BANK OF ENGLAND
PRUDENTIAL REGULATION AUTHORITY

FCA
FINANCIAL CONDUCT AUTHORITY

The failure of HBOS plc (HBOS)

A report by the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA)

November 2015

Contents

Foreword

This Report produced by the FCA and PRA explains why HBOS failed in October 2008 and sets out conclusions and recommendations. The story of the failure of HBOS is important both to provide a record of an event which required a major contribution by the public purse, and because it is a story of the failure of a bank that did not undertake complicated activity or so-called racy investment banking. HBOS was at root a simple bank that nonetheless managed to create a big problem. In covering the failure of HBOS, the FCA/PRA Report describes a period which is by now well-known and on which much commentary has already been written. For that reason, the general conclusions to be drawn from the Report are not new. Moreover, the recommendations have been kept concise by not including points where in our view major changes resulting from the lessons of the financial crisis have been implemented. Instead, the recommendations cover areas where work is under way but further steps are being taken to complete implementation.

The main period covered by the FCA/PRA Report (the Review Period) is from January 2005 to the point of failure, though it draws on earlier materials going back to the creation of HBOS in 2001, and some materials from after the point of failure where these provide useful context to help the explanation of failure. The Report draws on the records of the firm, the FSA as supervisor of HBOS, interviews with the main individuals involved, and other relevant outside sources. Documentary evidence has been combined with interviews, so that individuals could give their own account of events, and supplemented by representations received from a number of parties. Our approach has therefore been to write the extensive story of the failure, based on our assessment of this evidence base, and draw out conclusions and recommendations.

A second report, authored by Andrew Green QC, is being published at the same time. It provides an assessment of the FSA's enforcement actions in relation to the failure of HBOS.

Both the strategy and operation of HBOS, and its supervision by the FSA, were creatures of the time. The FCA/PRA Report sets out, against the backdrop of almost uninterrupted economic growth over a long period and the rapid development of financial markets, the story of an institution that became unsustainable through its poor risk management, in respect of the credit risk on the assets side of its balance sheet, and on the liabilities side in respect of the vulnerability of its funding. These are, of course, the fundamental building blocks of banking.

The FCA/PRA Report concludes that the Board and senior executive management of HBOS failed to set an appropriate strategy, and also failed to challenge a flawed business model that placed inappropriate reliance on continuous growth without due regard to the risks involved. As a case study, it amply illustrates the rationale for the Senior Managers and Certification Regime proposed by the Parliamentary Commission on Banking Standards (and legislated for in the Banking Reform Act).

The paradox of the story is that at the time, and indeed up until quite near to its failure, HBOS was widely regarded as a success story. The 2001 merger of Halifax and Bank of Scotland had yielded double-digit profit growth in all but one of the years up to end-2006 and analysts' and brokers' views were positive at least until early 2007. But, by this time, the seeds of the firm's destruction had already been sown as a flawed strategy led to a business model that was excessively vulnerable to an economic downturn and a dislocation in wholesale funding markets.

The FCA/PRA Report documents particular, and dominating, cases of inappropriate risk taking, in the management of credit risk in the Corporate Division, the expansion overseas without regard to the risks involved, and funding the assets of the bank. The strategy of HBOS put the growth of the bank above these considerations until it was too late and impossible to change course. The last point here is important. The management of a firm is not required to have perfect foresight. The criticism in the Report is not that management failed to predict that there would be a global financial crisis. Rather, they should have put in place strategies that could in combination accommodate and respond to, in a timely way, changes in external circumstances. With these strategies firms can for example raise new capital or adjust their funding with the necessary confidence of success. HBOS lacked these strategies.

The FSA's supervision of HBOS also reflected what turned out to be unsustainable conditions before the onset of the financial crisis. Prolonged economic growth and the appearance of financial stability created a prevailing view that the prudential regulation of financial firms should be 'light touch', thus limiting the challenge provided to firms including HBOS. In its supervision of HBOS, the FSA failed to establish an appropriate standard of safety and soundness. As described in the FSA's report into the failure of RBS, a major contributor to this failure was international standards of prudential regulations for banks which were inadequate in the case of capital adequacy and absent in the area of liquidity regulation. The same contributing factor is found to be at work in this Report. The supervisors of the time were not given appropriate tools (in terms of the policy framework of the day) to do their job.

Prior to the Review Period, the FSA had identified a number of the key risks that would ultimately contribute to the firm's failure. Nevertheless, the FSA subsequently failed to take appropriate steps to mitigate these risks effectively, thus indicating deficiencies in the FSA's prevailing approach to the supervision of systemically important firms. Supervisors need to employ their judgement and take appropriate actions in response where necessary. A particular challenge is to intervene sufficiently early when a firm is apparently successful but supervisors can identify weaknesses that are sufficiently important to pose a threat to the firm that is inconsistent with the objectives of supervision. HBOS was such a firm.

The FCA/PRA Report makes three recommendations for firms and three for the regulators. For firms the focus is on ensuring that safety and soundness and continuing viability are firmly embedded in the responsibilities of boards and senior management. This recommendation is directly relevant to the implementation of the new Senior Managers and Certification Regime. Closely linked is the second recommendation for firms, that boards should have an appropriate mix of experience which allows them to explore and challenge key business issues rigorously with executives. The third recommendation for firms is that senior managers should support and nurture a culture which adheres to both the spirit and letter of public policy requirements, thereby seeking to identify threats to the firm and engaging openly with regulators on how to mitigate the potential impact of these threats.

For regulators, the first recommendation is that they should be prepared to intervene consistent with their statutory objectives where they perceive a threat to those objectives. Where such intervention is warranted, the regulators must be willing and able to do so free from undue influence, in particular when financial market conditions appear to be benign and in the face of changing public policy priorities. An important lesson from the failure of HBOS is that outside conditions and priorities appear to have constrained such action in the period before the financial crisis. The second recommendation for regulators is that for UK firms with major overseas operations they should have the level of understanding of the international businesses to be able to engage effectively with the firm and local regulators. Much progress has been made in this area since the financial crisis but it is an area where continuous assessment of the state of international engagement is a wise approach. The last recommendation relates to the risk that the members of the Boards of the FCA and the PRA may be subject to actual or perceived conflicts of interest. While the Review found no evidence that James Crosby exercised inappropriate or undue influence over the supervision of HBOS while a member of the FSA Board, it is important that the policies that each of the FCA and the PRA have adopted are sufficient to manage these risks both on the appointment of a director and throughout their period of service.

Although HBOS failed in October 2008, work did not begin on the FCA/PRA Report until the end of 2012, following the conclusion of two related enforcement investigations by the FSA. It has therefore taken three years to produce the FCA/PRA Report. Both Reports have been subject to the so-called 'Maxwellisation' process to allow parties to comment on relevant sections. In addition, and only where appropriate, the consent of those parties has been sought to the publication of confidential information provided by or relating to them. Where consent was denied, the information covered by the requirement has been redacted from the Report and a footnote has been added indicating the redaction and its source. The processes of Maxwellisation and consent are legal requirements to which the regulatory authorities must adhere. They must be done thoroughly and fairly.

The key dates in the production of the FCA/PRA Report are:

October 2008	–	Failure of HBOS
March 2009	–	Commencement of enforcement investigations by the FSA
September 2012	–	Beginning of work on the Report
July 2014	–	Commencement of Maxwellisation of the Report
September 2015	–	Commencement of consent for publication of the Report
November 2015	–	Publication

The timetable means that the Reports have been produced under the previous legislative framework governing the FSA (which was the governing authority for around the first six months of work). This legislation was substantially changed by the Financial Services Act 2012, which established the FCA and PRA. Future reports of this nature will be carried out within a framework established under the specific provisions in the 2012 Act.

In April 2013 the Parliamentary Commission on Banking Standards (PCBS) produced its report on HBOS, *An Accident Waiting to Happen*. In line with the request of the PCBS, the FCA/PRA Report includes the response to specific issues raised in their report.

The cost of producing the two Reports is estimated to be £7 million. This represents the costs incurred by the authorities in addition to their regular budgets.

Oversight of the production of the FCA/PRA Report has been the responsibility of a steering committee drawn from the Boards of the two authorities. The committee was chaired by Brian Pomeroy, and I owe a great debt of thanks to Brian for his unstinting work to see the Report to its conclusion. My great thanks also go to colleagues from the two Boards, particularly Amelia Fletcher, Charles Randell, Mick McAteer and the late David Harker. Production of the Report was undertaken by a team from the staff of the PRA. I am hugely grateful to all members of the team for their work on the Report, and for the insights they have provided on the failure of HBOS. The Report has been produced alongside the regular activities of the two regulatory authorities and has not benefitted from dedicated additional resources. My thanks also go to Andrew Green QC for his work on the second Report, and for the challenge provided by Stuart Bernau and Iain Cornish following their appointment as Independent Reviewers by the Treasury Select Committee.

Andrew Bailey

Deputy Governor for Prudential Regulation and Chief Executive Officer of the Prudential Regulation Authority

Introduction

This Report was prepared in accordance with the Review's Terms of Reference which appear in Appendix 2. It is being published after a series of other investigations and publications:

- *The RBS Report*.(1) There are several notable parallels between the conclusions of the *RBS Report* and this Report. *The RBS Report* also built on other key reports, such as *The Review of the supervision of Northern Rock*(2) and *The Turner Review*.(3)

- The FSA's two Enforcement notices (against Bank of Scotland plc and Peter Cummings) regarding the oversight of the HBOS Corporate Division.(4) The Review used the underlying data that supported these two notices in the Report, and expanded it to provide a broader account of the activities of the Group beyond Corporate.

- The PCBS's report on HBOS – *An Accident Waiting to Happen*.(5) This report examined why HBOS failed and the implications of its failure for culture and standards in UK banking. It also identified a number of issues which it expected this Report to expand upon.(6) These are covered in Appendix 4 of this Report.

- The PRA's *Approach to Banking Supervision*.(7) This document has been used as a benchmark for recommendations and judgements on whether the failures identified in this case could reoccur.

Much of what has been said in these documents resonates with the findings of this Report. However, this Report is the product of a separate and independent Review. It is set out as a stand-alone document, summarising key analysis undertaken during previous reviews where relevant and with minimal referencing to earlier published documents.

The Report is structured into the following parts:

- Part 1 sets out the Executive summary and recommendations.

- Part 2 analyses how HBOS failed, with a particular focus on asset quality, funding and liquidity, and capital. It also outlines the external economic environment in which the firm operated and its approach to financial reporting in the final year.

- Part 3 examines the management, governance and culture of the HBOS Group, and the roles HBOS's Board and executive management had in the failure of the firm.

- Part 4 analyses the FSA's approach to supervision.

(1) *The RBS Report*: http://www.fsa.gov.uk/library/other_publications/miscellaneous/2011/rbs.shtml
(2) *The Northern Rock Report*: http://www.fsa.gov.uk/pubs/other/nr_report.pdf
(3) *The Turner Review*: http://www.fsa.gov.uk/pubs/other/turner_review.pdf
(4) *Final Notice for Bank of Scotland*: http://www.fsa.gov.uk/static/pubs/final/bankofscotlandplc.pdf and *Final Notice for Peter Cummings*: http://www.fsa.gov.uk/static/pubs/final/peter-cummings.pdf
(5) *An Accident Waiting to Happen*: http://www.publications.parliament.uk/pa/jt201213/jtselect/jtpcbs/144/144.pdf
(6) These issues are set out in paragraph 141 of the Parliamentary Commission on Banking Standards' report on HBOS: http://www.publications.parliament.uk/pa/jt201213/jtselect/jtpcbs/144/14410.htm
(7) http://www.bankofengland.co.uk/publications/Documents/praapproach/bankingappr1304.pdf

- Appendices to the Report include further information about the scope of the Review, the Review Period (January 2005 to October 2008) and the processes undertaken in preparing this Report. They also set out the Review's responses to questions posed by the PCBS.

The Review's Terms of Reference also referred to an assessment of the reasonableness of the scope of the FSA's enforcement investigations in relation to the failure of HBOS. This assessment, carried out by Andrew Green QC, is the subject of a separate report published together with this Report.

It is important to note that many of the judgements we have made in this Report, while based on the evidence provided by contemporaneous documentation and interviews conducted as part of this Review, have inevitably been formed with the benefit of hindsight. When using hindsight we do not imply any wrongdoing on the part of HBOS or those involved and we are not suggesting that what is clear in hindsight was necessarily clear to those involved at the time.

While hindsight has been widely used, there are still some decisions that we consider were poor at the time (even if the full consequences of those decisions could not have been envisaged). We have made it clear in the Report where this is our judgement.

We acknowledge that some topics that have attracted comment in this Report relate to assumptions and practices that were widely held or applied by the majority of market participants at the time, but in retrospect appear unjustified. In this respect, we are not suggesting that HBOS was generally an outlier. Where we have identified HBOS as an outlier this is explicit in the Report.

Finally, while this Report contains some judgements about the quality of decisions made, those statements carry no implication that either HBOS or any individual was guilty of any regulatory breach, other than as stated in the Final Notices. The judgements reached in this Report are views expressed in an attempt to understand and describe the causes of HBOS's failure for the purposes of satisfying a legitimate public interest. They can reasonably be subject to public debate.

1

Part 1
Executive summary and recommendations

1.1 Why did HBOS fail?

1. On 1 October 2008 HBOS was approaching a point at which it was no longer able to meet its liabilities as they fell due and so sought Emergency Liquidity Assistance (ELA) from the Bank of England.(1) While the failure of the Group was directly triggered by a lack of liquidity, in large part this reflected underlying concerns about the solvency of the firm – concerns that turned out to be justified.

2. The failure of HBOS can ultimately be explained by a combination of factors:

   - Its Board failed to instil a culture within the firm that balanced risk and return appropriately, and lacked sufficient experience and knowledge of banking.
   - The result was a flawed and unbalanced strategy and a business model with inherent vulnerabilities arising from an excessive focus on market share, asset growth and short-term profitability.
   - This approach permitted the firm's executive management to pursue rapid and uncontrolled growth of the Group's balance sheet, and led to an over-exposure to highly cyclical commercial real estate (CRE) at the peak of the economic cycle, lower quality lending, sizable exposures to entrepreneurs, increased leverage, and high and increasing reliance on wholesale funding. The risks involved were either not identified or, where identified, not fully understood by the firm.
   - There was a failure by the Board and control functions to challenge effectively executive management in pursuing this course or to ensure adequate mitigating actions.
   - HBOS's underlying balance sheet weaknesses made the Group extremely vulnerable to market shocks and ultimately failure as the crisis of the financial system intensified.
   - There was an extended period of inflows of capital to developed economies, resulting in low yields, declining awareness of risk and asset price bubbles, in which market discipline – investors, analysts, rating agencies and other third parties – failed to constrain firms from undertaking risky strategies.
   - An overall systemic crisis in which the banks in worse relative positions were extremely vulnerable to failure. HBOS was one such bank.

3. Ultimate responsibility for the failure of HBOS rests with its Board. However, another striking feature of HBOS's failure is how the FSA did not appreciate the full extent of the risks HBOS was running and did not take sufficient steps to intervene before it was too late.

4. The FSA Board and executive management failed to ensure that adequate resources were devoted to the supervision of large systemically important firms such as HBOS. This gave rise to:

(1) For the purposes of this Report, HBOS is deemed to have failed on the date it first received ELA, 1 October 2008 (see Appendix 1, '*Review Period, scope and processes followed*').

- a risk assessment process that was too reactive, with inadequate consideration of strategic and business model related risks;
- insufficient focus on the core prudential risk areas of asset quality and liquidity in a benign economic outlook; and
- too much trust being placed in the competence and capabilities of firms' senior management and control functions, with insufficient testing and challenge by the FSA.

5. The remainder of Part 1:

- outlines the history of the HBOS Group and the external economic environment in which it operated (Section 1.2);
- summarises the Review's assessment of:
  - HBOS's strategy (Section 1.3);
  - how HBOS failed, with particular focus on asset quality, reliance on wholesale funding and capital (Section 1.4);
  - the management, governance and culture of the HBOS Group (section 1.5);
  - the FSA's regulatory approach (Section 1.6); and
- makes recommendations arising from this Review (Section 1.7).

1.2 Background

1.2.1 The HBOS Group

6. The merger of the Halifax and Bank of Scotland in 2001 brought together a large former building society that had an extensive UK retail banking and insurance customer base, with a medium-sized bank that specialised in business banking and had a significant share of the Scottish corporate and retail banking markets.

7. A number of envisaged key benefits were cited at the outset of the merger. Increased market and product penetration opportunities, and an increased financial strength and deposit base were intended to enable the new firm to become one of the major UK banking groups and to challenge the existing 'Big 4'. The merger was also intended to partly address Bank of Scotland's limited customer deposits and consequent heavy reliance on wholesale markets to fund its lending business.

8. HBOS benefited from some synergies arising from the merger integration and the largely benign UK macroeconomic environment during the first half of the 2000s, and its profitability grew strongly. In the years leading up to the Review Period, HBOS pursued rapid growth across its retail and corporate lending businesses, while using its larger balance sheet to do increasingly large deals.

9. At the beginning of the Review Period, HBOS operated through five divisions:

   - Retail Division was the biggest part of the Group and was dominated by mortgage lending, which made up 92% of the division's loans and advances. HBOS was the largest mortgage lender in the UK throughout most of the Review Period, holding approximately a 20% market share.

   - Corporate Division mainly lent to UK businesses, with a significant share of the relationship banking market in Scotland (around 37%) and a much smaller one in England and Wales (3%). It focused on commercial property lending (where it and RBS were the two largest UK lenders to the market) and other property-related businesses such as construction, hotels and renting, while also lending to sectors such as manufacturing and transport.

   - International Division was a collection of insurance and banking businesses that had little in common, other than that they were not based in the UK. Parts of the International Division grew very rapidly during the period, particularly the Australian and Irish businesses, but overall it remained the smallest part of the Group (by assets) throughout.

   - Treasury Division managed funding and liquidity for the Group but also acted as a profit centre, carrying out a small amount of proprietary trading.

   - Insurance and Investment Division(2) was responsible for underwriting and administration of the insurance business, both life and general, within the Group.

(2) The performance of the Insurance and Investment Division did not materially contribute to the failure of the Group, so this division is not in the scope of this Review (see Appendix 1, '*Review Period, scope and processes followed*').

1.2.2 External economic environment

10. Halifax and Bank of Scotland merged during a period of heightened corporate activity, in the middle of an economic cycle that had begun in the early 1990s. UK domestic economic growth had been relatively steady since the recession of the early 1990s, resulting in an extraordinarily long period (around 60 quarters) of continuous expansion. The growth in the financial services sector was more than twice as fast as the economy as a whole, averaging 6% per annum in the decade preceding the crisis, and increasing its share of nominal gross domestic product (GDP) to around 10%. Confidence in the future prospects of the economy was reflected in both bank and non-bank equity prices, which rose steadily from the start of 2003 until 2007.

11. As the benign conditions persisted for longer and longer, many perceived that a new paradigm of economic stability had been established. Commentators underestimated the risks that were building up in advanced economies as low interest rates and cheap – often cross-border – funding flattered banks' performance, and complex innovation increased the interconnectedness of financial firms.

12. The financial and economic trends in the run up to the crisis were unsustainable. Some of the incipient risks were identified and highlighted by central banks, regulators and other analysts but many of the trends had been evident for many years, in some cases decades, without risks crystallising in developed economies. Few predicted the severity and longevity of the crisis that was to occur.

1.3 HBOS's strategy during the Review Period

13. During the early part of the Review Period, HBOS pursued lending and treasury investment strategies which led to an increase in the risk profile of the Group, and made it increasingly vulnerable to an economic downturn.

14. HBOS's strategy focused primarily on revenue growth combined with strong cost control. It was simple and seemed compelling to many, both within and outside the Group, and for a period was partly fuelled by benefits from the merger. However, this strategy remained broadly unchanged from the merger and through the Review Period, despite the increase in risk in the external environment.

15. HBOS's strategy was articulated within its annual business plans. Certain features of the strategy were broadly consistent throughout the Review Period, including:

    - a return on equity goal of around 20%;
    - aggressive growth targets;
    - gaining a market share of 15-20% in all the key markets in which it was involved (the starting position differed between business lines); and
    - tight cost control, which was viewed as a competitive advantage.

16. What the strategy lacked was a clear articulation of the risks faced by the firm and its risk appetite in pursuing its objectives. As such, there were no effective risk-based measures that would constrain asset growth and prevent the strategy from becoming unbalanced and disconnected from the firm's funding and liquidity positions.

17. The Group put itself under pressure to maintain an increasing level of income. As margins declined on all forms of lending, a search for yield pushed it towards more risky propositions. Each of the lending divisions experienced an increase in its risk profile as it sought to grow income levels. Retail expanded its share of more risky specialist lending segments. Corporate increased its leveraged loans business and both Corporate and International generally increased the size and complexity of their deals, while also expanding their property lending, much of which was secondary and tertiary property. The decision to expand growth in HBOS's international operations was intended to provide diversification. In practice, it increased HBOS's overall exposure to high-risk commercial property. The Board failed to identify the extent to which HBOS was moving up the risk curve.

18. The Group sought to reduce reliance on interest income, but only made substantial progress in Corporate. A significant part of non-interest income in this division arose from taking equity stakes in businesses which were then sold down. This was a risky strategy as it created a reliance on a form of income that was cyclical and not sustainable in a downturn.

19. Key strategic decisions were taken by the Board which aggravated rather than improved the overall risk profile. An expectation of an increasingly difficult UK retail environment in 2007 led to a decision to rely more heavily on revenue from the Corporate Division, increasing the firm's exposure to riskier sectors and market segments, at what is now known to have been the peak of

the cycle. Certain of the high-risk features of Corporate's business model, such as integrated lending, were exported to the Group's Australian and Irish businesses. Despite an aim of the merger being to reduce the size of wholesale funding, the Group pursued an asset-led growth strategy that increased the size of and reliance on wholesale funding.

20. Following the onset of the crisis, the perception that HBOS had a highly risky strategy exposed to the UK property market was an important factor in its deteriorating external reputation.

21. HBOS's business model and strategy during the Review Period are considered in more detail in Part 2, Section 2.3.3, '*HBOS's strategy and business plans: 2004 to 2008*'. The role of the Board in formulating this strategy is discussed further in Section 1.5.2 below and in Part 3, Section 3.3.2, '*Key failings of the Group Board, Chairman and CEOs*'.

1.4 How HBOS failed

1.4.1 The final year

22. During 2007, vulnerabilities in the global financial system which had arisen during the long period of relative economic stability became increasingly apparent. Key vulnerabilities included:

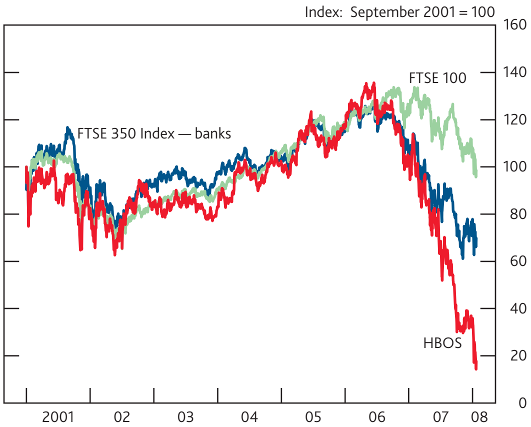
- low real interest rates resulting in a search for yield and investment in riskier (and often more complex and opaque) financial products with higher nominal returns;
- increasing dependence by many banks on wholesale financial markets for funding and the growth of a shadow banking sector;
- unsustainable rises in commercial and retail property prices; and
- increasing leverage and indebtedness in the corporate, household and financial sectors.

23. Strains that had manifested themselves first in the US sub-prime mortgage market started to spread through global financial markets, impairing interbank liquidity internationally and in the United Kingdom. The impact of this spread further during summer 2007 when two Bear Stearns hedge funds effectively collapsed in July, shortly followed by the suspension of withdrawals from three investment funds managed by BNP Paribas. There was a significant reduction of global interbank liquidity as investors grew concerned about counterparties' exposures to bad debts and each other, and liquidity risks flowed back from the shadow banking sector to the banks. In September 2007, Northern Rock – which was known for its aggressive business strategy – sought ELA from the Bank of England and experienced a retail run.

24. HBOS invoked its contingency funding plan in September 2007. The plan covered early warning indicators, management escalation and actions to be taken. HBOS had committed to provide funding to a special purpose vehicle (known as Grampian) if the latter could not continue to finance its assets by issuing commercial paper in the market. As a result of the market issues, this facility, supporting £18.6 billion of assets, began to drawdown from August 2007. However, the Group also attracted £7.9 billion of additional retail and corporate deposits in 2007 Q4 as investors moved assets out of riskier investments. At this stage, the firm assumed that the dislocation would be temporary.

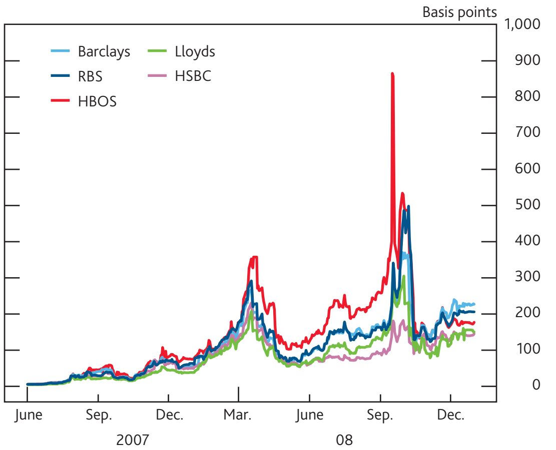
25. From a lending perspective, HBOS recognised that it needed to reduce asset growth and took action to address this. The bulk of the proposed reduction was targeted at the International Division. It was decided that Corporate would continue to lend, with a particular emphasis on supporting its existing customers. This decision was influenced by concerns about damaging HBOS's franchise if Corporate stopped lending and by the firm's ethos of 'lending through the cycle'. However, lending continued at well above planned levels throughout 2007 in both Corporate and International, and loans were in many cases made to new customers, not just existing ones.

Chart 1.1: HBOS and other large UK banks' share prices(a)



(a) Source: Bloomberg.

Chart 1.2: Large UK banks' three-year CDS spreads on subordinated debt(a)



(a) Source: Bloomberg.

26. In the context of the growing crisis, banks perceived as weak became increasingly vulnerable to failure. Brokers' views of HBOS were mixed during 2007. While there were some who continued to regard HBOS very positively, others became more pessimistic due to concerns about an impending downturn, with a few being particularly vociferous on account of the nature of the business HBOS had built. Analysis of broker reports shows that 'buy' remained the principal recommendation throughout 2007. Despite this, by 12 December 2007, before the pre-close Trading Statement the following day, HBOS's share price was 26% down on the start of the year, underperforming the sector as a whole.

27. Information contained in HBOS's December 2007 pre-close Trading Statement and the more detailed 2007 Preliminary Results announcement made on 27 February 2008, appears to have taken the market by surprise and significantly eroded the market's confidence in HBOS. This included: disclosure of its debt securities portfolio of £81 billion, of which asset-backed securities (ABS) exposures accounted for £41.9 billion; and disclosure of Alt-A assets worth £7 billion. HBOS's share price fell by 13% in the week following the pre-close Trading Statement and 23% in the week of the Preliminary Results announcement and continued to fall sharply during 2008, as shown in Chart 1.1.

28. HBOS's position was further tested less than three weeks later. On 19 March 2008, a British bank – named by some as HBOS – was rumoured to be facing severe strain following the collapse of the US investment house Bear Stearns, allegedly prompting the Governor of the Bank of England to cancel travel plans. Both the FSA and the Bank of England refuted the rumours and HBOS's share price partially recovered its sharp intra-day falls. Against a backdrop of uncertain market conditions at the time, the incident highlighted HBOS's apparent vulnerability to market gossip. Around this time, HBOS's credit default swap (CDS) spreads spiked and widened relative to those of other large UK banks, as shown in Chart 1.2.

29. There was a gradual deterioration in the maturity profile of the firm's liabilities from this point as maturing long-term funding was replaced increasingly by short-dated instruments. It appears there was reluctance from HBOS to 'pay up' for longer term funding, even when it was available, to avoid the market interpreting this as a distress signal.

30. As its funding position continued to deteriorate, HBOS revised its plans. The firm took a number of short-term actions to address its vulnerable position, including seeking to grow its customer deposit base. Decisive action was finally taken to halt balance sheet growth. From a funding perspective, HBOS significantly increased its securitisation programme to access the Bank of

England's Special Liquidity Scheme (SLS). SLS, which had been launched by the Bank in April 2008, enabled UK banks to access funding by exchanging assets for Treasury Bills. HBOS used this facility from the first month it was established and, by September 2008, it was the firm's primary source of new secured funding.

31. In addition, in April 2008 HBOS announced that it would raise £4 billion of capital via a rights issue, with the stated objectives of: rebasing the Group to stronger capital ratios; consolidating the Group's strengths in its core markets; mitigating the increased volatility of the Group's regulatory capital under Basel II; and covering the fall in market value of the Treasury portfolio.

32. These actions did little, however, to alleviate market participants' concerns regarding the sustainability of the Group's business model, and in particular its exposures to the UK property market and reliance on wholesale funding. A further deterioration in market sentiment towards the banking sector generally, as well as HBOS specifically, resulted in a subscription rate to the rights issue of just 8.29%, with underwriters left to take up the remaining proportion of shares. By end-July 2008, HBOS's share price had lost 60% of its value at the beginning of the year and its CDS spreads were increasingly wider than those of other large UK banks.

33. On 15 September 2008, Lehman Brothers failed, disproving the market's belief that certain institutions were 'too big to fail'. The result was a significant dislocation to financial markets and further reduction in interbank liquidity, aggravating funding conditions for all banks. HBOS, however, with its massive wholesale funding requirement, was particularly affected and was largely only able to secure funding on an overnight basis.

34. By the time that Lehman Brothers collapsed, HBOS had no real funding options left, having already used a significant proportion of its collateral eligible for central bank funding schemes. In the following days, it came under acute and sustained funding pressure, including receiving – and in some cases acceding to – requests to buy back debt instruments before maturity.

35. Furthermore, HBOS began to see material outflows of customer deposits. The Irish and Australian businesses were also experiencing customer withdrawals and so required additional funding from the United Kingdom to meet local regulatory requirements. As a result of these factors, HBOS faced an additional, unexpected funding need of £12.5 billion in the week after Lehman Brothers failed.

36. On 17 September 2008, two days after the collapse of Lehman Brothers, HBOS publicly confirmed it was in discussion with Lloyds TSB concerning its takeover, with the takeover announced on 18 September 2008. It is debatable what impact this announcement had on HBOS's funding position. While there was clear market relief immediately after the takeover announcement, the short-to-medium term consensus was negative. There was a view among HBOS management at the time that some institutions reduced their individual lending limits to the two banks to a lower combined limit (with the reduction biting for HBOS not Lloyds TSB), thus reducing HBOS's borrowing capacity.

37. Overall, the firm's liquidity position deteriorated dramatically in the second half of September 2008. Further deposit outflows resulted in an additional £2 billion funding need over the last week of September, and increasing volumes of overnight funding meant that daily wholesale maturities were between £15 billion and £20 billion. On 1 October 2008, HBOS was approaching a point at which it was no longer able to meet its liabilities as they fell due. The firm had exhausted its eligible collateral for use in the SLS and so sought ELA from the Bank of England.

38. Further details regarding HBOS's final year can be found in Part 2: Section 2.8.5, '*Key events and triggers: what were the events which triggered the liquidity crisis leading to the firm's failure?*'; and Section 2.10, '*Shifting market perceptions of HBOS*'.

39. The market dislocation following the failure of Lehman Brothers was the proximate, but not the ultimate, cause of HBOS's failure. HBOS failed because of the market's concerns about the composition of its balance sheet and the risk within it, relative to its capital and liquidity buffers, which was exposed by the dislocation of the market following Lehman Brothers' failure. The remainder of this section considers the poor quality of assets on HBOS's balance sheet, as well as the vulnerabilities of its capital, funding and liquidity positions over the Review Period.

1.4.2 Asset quality

40. A key feature of HBOS's balance sheet was its concentration in property, particularly commercial property. HBOS saw real estate lending not just as a core competence but as 'safe' lending. As such, each division was heavily exposed to property and property-related sectors. This was well known to the market. During the Review Period, exposure to property and property-related interests accounted for around 75% to 80% of all loans and advances to customers. A concentrated exposure of this magnitude to any sector carries risks, but it should be possible for such risks to be managed effectively. In this case, however, the risk to HBOS's long-term sustainability was heightened by a considerable proportion of its exposures being to the highly cyclical CRE sector. By the end of the Review Period, £76 billion of the Corporate Division's portfolio was exposed to commercial property or related sectors. In addition, approximately £12 billion of the International Division's Irish portfolio and £6 billion of its Australian portfolio was exposed to commercial property or related sectors.

41. A second key feature was its lower quality lending. The Corporate Division actively targeted 'sub-investment grade' borrowers. The International Division's weak credit assessments led the businesses to take on lower-quality exposures than was appreciated. Both Corporate and International pursued opportunities to hold riskier, junior debt and to provide equity to borrowers. Meanwhile, the Retail Division was one of the largest lenders in the United Kingdom of higher risk self-certified mortgages, while it moved up the risk curve to maintain buy-to-let (BTL) market share.

42. A third key feature was its significant support of entrepreneurs in their pursuit of different business ventures. This was a characteristic of both Corporate and International (in particular, Ireland) and it led to sizeable single-name exposures. At the end of 2005 the Corporate Division's top 30 exposures represented 15% (£19.2 billion) of the division's portfolio. By the end of September 2008, the top 30 exposures represented 21% of the division's portfolio (£30.9 billion). The largest of these exposures was £1.8 billion and there were fourteen exposures in excess of £1 billion.

43. A fourth key feature was its rapid expansion. Total Group assets grew from £477 billion in 2004 to £690 billion in 2008, giving a compound annual growth rate of 10% during the period (Table 1.1). Moreover, the Group rapidly grew its higher risk assets, such as CRE, at the top of the economic cycle at a time when there was downward pressure on margins and lending terms, including high leverage and weak covenants.

44. In 2007, the Corporate and International Divisions grew loans and advances by 22% and 38%[3] respectively, as the firm sought to increase revenues in these areas partly to compensate for the decline in the Group's traditional mainstream retail mortgage lending.

45. In the Corporate Division, although the volumes of new loans sanctioned after August 2007 were not as high as the volumes of new loans sanctioned in the first seven months of the year, the division's exposures continued to grow strongly to the end of 2007. As well as new lending,

(3) On a like-for-like basis after allowing for the transfer of businesses between the divisions in 2007.

1

the continued growth of Corporate's balance sheet in 2007 was partly due to the completion of transactions sanctioned earlier in the year and customers drawing down on committed facilities. In addition, the ongoing closure of the syndication market meant that Corporate was unable to sell-down, as originally intended, significant large exposures that it had agreed to underwrite in full. The Corporate Division's increasing exposures placed considerable pressure on the firm's funding position.

46. Taking into account the proportion of loans that came to the end of their terms or were otherwise repaid in 2007, Corporate's new lending book grew by approximately 50% in that year. Even into 2008, the division was looking to pick up from other banks exiting the market assets regarded as cheap.

Table 1.1: HBOS total assets and growth by division 2004-2008 (as at 31 December)[(a)]

£ billion	2004	2005	2006	2007	2008	Compound annual growth
Retail	209	225	243	260	266	6%
Corporate	82	87	97	122	128	12%
International	37	50	61	76	68	16%
Banking divisions	**328**	**362**	**401**	**458**	**462**	**9%**
Treasury and Asset Management	85	107	107	120	147	15%
Total banking activities	**413**	**469**	**508**	**578**	**609**	**10%**
Insurance and other group items	64	72	83	89	81	6%
Total group assets	**477**	**541**	**591**	**667**	**690**	**10%**

(a) Source: HBOS *Annual Reports and Accounts* and Review calculations. 2004 has been adjusted to reflect the introduction of International Financial Reporting Standards from 2005. A number of transfers of business took place between the divisions in 2007 and 2008. No adjustments have been made to restate the earlier periods for these transfers (e.g. the European corporate business of International transferred to Corporate in 2007 and is only shown as part of Corporate for 2007 and later. Prior to 2007 this business is included within International).

47. A final aspect was that Treasury invested in ABS as a significant part of its liquidity portfolio on the assumption that these assets could be sold or used as collateral to raise secured funding in a liquidity stress. As the stress that developed from 2007 onwards involved a lack of confidence in the assets that backed these securities and then the securities themselves, this assumption proved to be wrong.

48. HBOS's approach was not unique in all respects. Most of the leading UK banks during the period had high return targets and had grown significantly, while some also had significant exposures to commercial property. However, the combination of all of these factors, when also combined with HBOS's exposures to highly leveraged businesses, single names and riskier junior debt/equity, led to HBOS being particularly vulnerable to an economic downturn.

49. Further details regarding the asset quality of the different divisions can be found in Part 2: Section 2.4, '*Asset quality – Corporate Division*'; Section 2.5, '*Asset quality – International Division*'; Section 2.6, '*Asset quality – Retail Division*'; and Section 2.7, '*Asset quality – Treasury Division*'.

Impairment losses – a consequence of poor asset quality

50. In the three-year period from 2005 to 2007, the annual impairment losses recognised in the HBOS Group's income statement[(4)] ranged between £1.7 billion and £2.1 billion. The losses on the Group's lending portfolios increased markedly from September 2008 onwards, with impairment losses of £13.5 billion being ultimately recognised for the 2008 year-end.

51. Within Corporate, despite the deteriorating economic outlook in 2008, the business functions were reluctant to accept that the loans were going bad, and were reluctant to re-categorise and

(4) An explanation of impairment losses and related terms is included in Question 1 of the Parliamentary Commission on Banking Standards, in Appendix 4.

escalate them to the division's specialist 'impaired assets' team. In many cases, when they were recategorised, the business functions and executive management maintained their expectation that they would be able to implement 'workout solutions' on the distressed loans and thereby suffer no loss or only a small one. As more and more Corporate loans deteriorated, the division's impaired assets team became overwhelmed with their sheer volume and was unable to properly re-categorise the loans in a timely fashion. All of these factors meant that difficult decisions about deteriorating loans had to be taken later, and in a declining market, at higher ultimate cost.

52. The optimism also meant that throughout 2008 the division proposed levels of provisions which did not reflect the declining market conditions, and were increased following intensive discussions with the firm's external auditors. Even then, the firm consistently chose the level of Corporate provisions at the least prudent end of the range deemed acceptable by its external auditors, though the approach had changed by the time that the 2008 year-end impairment figures were finalised in early 2009.

53. In its Annual Report and Accounts for the year ending 31 December 2007 (published early 2008) HBOS reported a profit before tax of £5.5 billion. The Annual Report and Accounts for 2008 (published early 2009) showed a loss of £11 billion. In its half-year interim results for the year to June 2008 (published 31 July 2008), the charge for Group impairment losses was £1.3 billion; yet by year-end 2008 this figure had risen to £12 billion. The deterioration in the quality of HBOS's loan book and the speed with which it all happened, are a notable part of the HBOS story. Section 2.11, '*HBOS financial reporting*', in Part 2 of this Report draws extensively on the published annual reports and accounts and the various interim financial statements issued by HBOS in relation to the Review Period. It also draws heavily on the audits and other reviews and reports which were presented to HBOS Board and senior management by KPMG.[5] This material is included to show how the losses emerged over time, what information was available to HBOS's Board and senior management, what warnings were given to HBOS's Board and senior management, what decisions were taken as a result, and how these losses were recognised in the published financial statements. It is not within the Terms of Reference for this Review to opine on the content of the annual reports and accounts or the various interim financial statements which HBOS issued throughout the Review Period. Similarly, it is not within the Terms of Reference for this review to opine on whether the formal audits, reviews or other work undertaken by KPMG in relation to HBOS met the required standards – these are matters for the Financial Reporting Council (FRC). With that in mind, in the course of the Review the PRA and FCA remained in regular contact with the FRC and wrote to the FRC inviting it to consider whether there were grounds to investigate KPMG and/or senior KPMG people in relation to the audits of HBOS's financial statements for 2007 and 2008 and, by extension, HBOS senior management. The FRC carried out a review into these matters and advised that the criteria for commencing an investigation were not met. The FRC has indicated that it will consider any relevant new information contained in the HBOS Report once finalised and published.

54. From the end of the Review Period in 2008 until 2011, HBOS recognised a total of £52.6 billion of impairment losses in its income statement: £44.7 billion were referable to the Group's lending portfolios, with the remainder from its securities holdings.

55. Table 1.2 shows the recognised impairment losses of the Group on its loans and debt securities split by division. By far the worst-performing divisions were Corporate and International, with £21.9 billion and £15.5 billion of impairments, equivalent to a fifth and a quarter of total loans and advances at end 2008 respectively. Within these divisions, losses were predominantly incurred on their commercial property portfolios. While in mid-2008 the market was expecting HBOS to incur losses, the magnitude of the losses was not predicted. The impact of the crisis on HBOS's Retail book was less severe than its impact on the Corporate and International books.

(5) KPMG was HBOS's external auditor from the Group's foundation in 2001 until the year-end 2008.

56. There has been limited recovery of HBOS's impairment losses after the end of the Review Period. Between 2009 and 2013, the Group decided £39.6 billion of the impairment losses would ultimately be irrecoverable while just under £0.9 billion was recovered. Even assuming all remaining legacy loans perform in the long run, HBOS could not have survived this level of write-offs without the support from Lloyds TSB and the government.

Table 1.2: HBOS Group recognised impairments in the income statement 2008 to 2011[(a),(b)]

£ billion	Loans and advances, end 2008[(c)]	Impairments 2008	2009	2010	2011	Cumulative 2008 to 11	Loss as percentage of 2008 loans and advances
Retail	258	2.2	2.0	1.4	1.0	6.6	3%
Corporate	123	6.7	11.1	3.2	0.9	21.9	18%
International	62	1.0	5.3	5.8	3.4	15.5	25%
Treasury	79	2.9	2.8	0.5	0.7	6.9	9%
Other		0.7	(0.1)	0.0	1.1	1.7	
Total	**522**	**13.5**	**21.1**	**10.9**	**7.1**	**52.6**	**10%**

(a) HBOS *Annual Reports and Accounts* 2008-2011. The Review Team has used its judgement to allocate losses to the HBOS divisions, as following LBG's acquisition, the HBOS divisional structure was dissolved.
(b) The impairments for Retail, Corporate and International are impairment losses on loans and advances. The impairments for Treasury are impairment losses on debt securities. Other impairments are those that the Review has been unable to allocate to a division, as well as 2008 impairments on Corporate's debt securities. Part 2, Section 2.3.6 and Appendix 4, PCBS question 1 set out in more detail why it has not been possible to allocate all impairments to a particular division.
(c) Gross loans and advances, except for the Treasury Division which includes £76.7 billion of debt securities.

57. The depth and length of the recession as a result of the crisis starting in 2007 undoubtedly contributed to a number of companies experiencing financial difficulties and going into administration. However, it was the policies and actions that HBOS pursued in the benign times prior to the crisis that determined the extent to which it was exposed to the downturn and how resilient it was. In this regard, the policies and actions created a business model that was highly cyclical and amplified the effects of the recession leading to significant losses.

58. HBOS's losses are considered further at the end of each section on asset quality in Part 2 referred to above, and also in the response to Question 1 of the '*Questions from the Parliamentary Commission on Banking Standards*' at Appendix 4.

1.4.3 Underlying balance sheet vulnerabilities

59. By the start of the crisis in mid-2007, HBOS had developed the underlying balance sheet vulnerabilities which would ultimately lead to its failure. These included insufficient capital for the risks on its books; a large funding gap and dependence on wholesale funding; and ABS in the Treasury liquidity portfolio. The firm's asset-led growth strategy exacerbated these vulnerabilities.

Reliance on wholesale funding

60. By the end of September 2008, HBOS was no longer able to meet its needs from the wholesale market and was facing a withdrawal of customer deposits. On 1 October 2008, the Bank of England provided HBOS with ELA so that the firm would be able to continue to meet its liabilities as they fell due.

61. The rapid expansion of its balance sheet placed pressure on HBOS's ability to fund itself. HBOS's retail funding struggled to keep pace with the Group's lending growth, with customer deposits growing at an average annual rate of 5% a year during the Review Period, compared with a customer loan growth rate of 10%. As a result, HBOS increasingly accessed wholesale financial

markets as a source of funding, raising its wholesale borrowing(6) from £187 billion at the end of 2004 to £282 billion at end-2007.

62. The disparity between the amount HBOS lent to its customers and the amount it held in customer deposits was further highlighted by HBOS's loan-to-deposit ratio, which increased from 143% at the time of the merger to 170% at the end of 2007. While this was below the Bank of Scotland level of 194% immediately before the merger, it was well above the ratios of HBOS's clearing bank competitors and at the top of the range for UK mortgage banks, with the exception of Northern Rock which failed. By the end of 2008, HBOS's loan-to-deposit ratio had reached 192%.

63. The management and Board of HBOS recognised that an over reliance on wholesale funding was a weakness but this was never tackled as a key risk to the stability of the business. Instead, the possible need for additional funding was viewed as a risk to further asset growth, and was considered mainly in those terms. So, for example, higher levels of customer deposits were seen as a way of increasing lending capacity rather than reducing liquidity risk.

64. As early as 2004, the HBOS Board took steps to lengthen the tenor of its wholesale funding and diversify the sources of wholesale funding. As a result, the percentage of HBOS's funding with a maturity of over one year increased from 33.5% at end-2003 to a peak of 47.5% at end-2006.

65. Nevertheless, the absolute size of its funding requirement meant that HBOS still had large volumes of short-term funding with tenors of one and three months (at their peak in March 2008 of approximately £64 billion and £61 billion respectively).(7)

66. In addition, the structure of HBOS's funding requirement made it particularly vulnerable to closure of wholesale funding markets. As the largest participant in the UK residential mortgage-backed securities (RMBS) market from 2003, HBOS was reliant on securitisation as a source of funding. When uncertainty grew regarding the credit quality of the assets underlying these securities from mid-2007, new business could no longer be securitised creating a need to find alternative funding. In addition, as referred to above, HBOS needed to provide funding to its special purpose vehicle, Grampian.

67. HBOS's own liquidity standard was significantly more stringent than the prevailing – albeit inadequate – regulatory standard of the time: the firm having set itself a requirement that it should hold sufficient liquidity to meet a one-month wholesale outflow. HBOS had grown its liquidity buffer from £84.4 billion in 2004 to £147.8 billion in 2008.

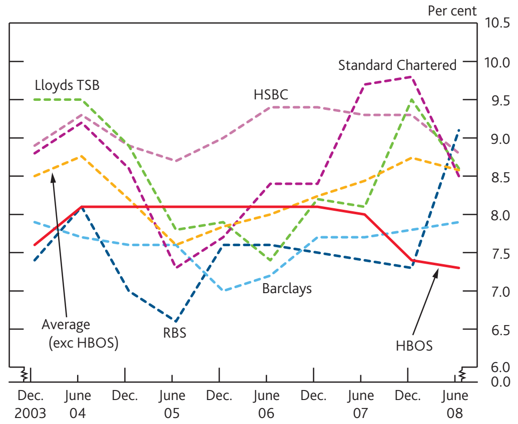
68. However, in 2004 the HBOS Board decided to change the composition of Treasury assets comprising its liquidity buffer from a majority of gilts to a majority of other, typically AAA-rated(8) ABS. This allowed Treasury to increase the yield on its assets, in effect becoming a profit centre by taking on higher-risk assets that it believed could be used to generate liquidity at a time of stress. At the time, ABS markets were deep and growing and there was an active repo market. However, this market was still relatively immature and had not been tested in a downturn.

69. The decision to invest in ABS assets that were not sufficiently distinct from the other assets of the firm further concentrated HBOS's balance sheet in property-related assets. These assets proved insufficiently liquid when financial market conditions worsened and then deteriorated further following the failure of Lehman Brothers.

(6) Defined for this purpose as the sum of 'deposits by banks' and 'debt securities in issue' as stated in the annual reports and accounts.
(7) That said, firms with different business models were running positions with much larger volumes of short-term funding – data submitted to the FSA indicates that other firms had to refinance one-week positions significantly greater than HBOS's one-month position.
(8) The standard definition of an AAA rating is that the issuer has extremely strong capacity to meet its financial commitments.

1

Chart 1.3: UK banks' published Tier 1 capital ratios[a]



(a) Source: *Annual Reports and Accounts and Interim Results*.

70. The magnitude and structure of the firm's wholesale funding, the size of and need to finance Grampian, and the composition of HBOS's liquidity portfolio contributed to its eventual failure.

71. See Part 2, Section 2.8, '*Funding and liquidity*' for further details.

Capital

72. The Group reported Tier 1 and Total Capital ratios of 8% and 12% respectively at 30 June 2007[9] which were significantly in excess of the regulatory minima and were firmly within the range of its peer group (Chart 1.3)[10]. There is no evidence that HBOS breached regulatory capital requirements during the Review Period and it was only from late 2007 that the firm's capital position started to look particularly weak compared to the other major UK banks.

73. Prior to 1 January 2008, the regulatory capital regime was Basel I and subsequently was Basel II. These regimes set a minimum standard and generally UK firms, including HBOS, held more capital than the minimum. A critical weakness of the regimes was that they did not require capital buffers to be built up in the good times to absorb losses in the bad.

74. While regulatory capital ratios remained stable and looked robust, leverage had increased for HBOS and the banking industry as a whole between 2005 and 2007. At the end of 2007, HBOS had £1 of shareholders' equity supporting every £30 of assets. If account is taken of the significant commitments (such as committed but undrawn facilities) which were not on the firm's balance sheet, the true leverage of the firm was significantly higher than 30:1. With a smaller proportion of capital supporting an ever growing balance sheet, the potential impact of a downturn on the firm had increased. For HBOS, poor analysis of risks and overly competitive pricing meant that risk and reward had become unbalanced, and these vulnerabilities elevated.

75. See Part 2, Section 2.9, '*Capital*' for further details.

(9) Reported Tier 1 and total capital ratios do not equate completely to the regulatory minimum requirements in force. This is ostensibly due to the treatment of innovative Tier 1 instruments, which were treated as Tier 2 instruments for the purpose of minimum regulatory requirements, but were eligible as innovative Tier 1 instruments (subject to limits) for the purpose of meeting individual capital ratios (ICRs) set by the FSA.
(10) See also Part 2, Chart 2.67.

1.5 Management, governance and culture

76. The following section outlines the Review's findings as to the management, governance and culture of HBOS. In their design, the management and governance arrangements adopted by HBOS were broadly appropriate for the federal structure of the firm that was created in 2001. However, they proved to be ineffective in their application. Failings in the management, governance and culture of the firm had a direct impact on the poor quality and heavily concentrated nature of HBOS's lending, especially in its Corporate and International Divisions. These failings were the underlying cause of the firm's financial vulnerabilities summarised in Section 1.4.

1.5.1 Board composition and challenge to executive management

77. The composition, size and structure of the HBOS Board were typical for a large UK bank at the time. However, it failed to provide effective challenge to the firm's executive management. Lord Dennis Stevenson of Coddenham was HBOS Group Chairman throughout the Review Period and had overall responsibility for leadership of the Board, setting the agenda and ensuring its effectiveness.

78. As a group, the non-executive directors (NEDs) on the Board lacked sufficient experience and knowledge of banking. Of the twelve NEDs who served on the Board during the Review Period, only one had a background in banking and he was appointed in May 2007. The NEDs were all people who had achieved a high degree of success in their own fields and had significant experience of serving on corporate boards. However, this lack of experience and knowledge of banking hindered the NEDs' ability to provide effective challenge to executive management. As a result, risk was given insufficient time, attention, focus and priority by the Board. Indeed, the Review found a lack of contemporaneous evidence of debate and challenge at Board meetings around key areas of risk faced by the Group, including:

- the Group's continued over-reliance on wholesale funding;
- the risks associated with the firm's rapid growth and philosophy of 'lending through the cycle', in particular the ability of internal controls to keep pace with this growth;
- the Corporate Division's claims that it had unique expertise in commercial property and a significant competitive advantage over its peers with its integrated finance business;
- the risks taken by the Corporate Division in the course of exceeding its lending targets in 2006 and 2007; and
- the replication of strategies used in the UK by the International Division in Ireland and Australia.

79. A recurrent theme in Board evaluations was a desire that the Chairman should promote more open discussion in Board meetings. Although directors told the Review that many points were raised in bilateral discussions outside Board meetings, these can be no substitute for an effective board process which enables NEDs as a group to challenge management.

80. The lack of experience and knowledge of banking amongst the NEDs was compounded by similar lack of banking experience within the executive management team. In particular, both of the Group Chief Executive Officers (CEOs) during the Review Period had limited banking experience and only Mr Peter Cummings and Mr Colin Matthew (the Chief Executives of the Corporate and International Divisions respectively) had experience of corporate banking. As a result, the Board was heavily reliant on Mr Cummings and Mr Matthew to oversee the firm's corporate banking businesses.

81. Further details regarding the Board can be found in Part 3: Section 3.2, '*Design of the management and governance arrangements*' and Section 3.3, '*Management and governance failings in practice*'.

1.5.2 Formation of strategy and risk appetite

82. One of the key factors in the demise of HBOS was the failure to establish an appropriate strategy for the Group, set in the context of clearly identified risks and measures to quantify and control risk. Approving the strategy, which was developed by the CEO and Group Finance Director in consultation with the Chairman, was the responsibility of the Board. The Board, however, played a limited role in the development of the Group business strategy.

83. Mr James Crosby(11) (up to July 2006) and Mr Andy Hornby (from August 2006) were the Group CEOs during the Review Period, to whom the HBOS Board delegated responsibility for strategic planning.

84. A crucial weakness of HBOS's strategic approach was that it was developed and pursued in the absence of a clearly defined risk appetite statement for the Group as a whole and the ability to aggregate risks at Group level. As a result, key risks such as HBOS's reliance on wholesale funding, were not adequately addressed by the strategies of each of the operating divisions. Further, HBOS used the annual divisional business planning process as the main mechanism for reviewing the Group's strategy. This meant that discussions about the firm's strategy and risk appetite tended to focus on performance targets.

85. The formulation of HBOS's strategy and risk appetite are considered further in Part 3, Section 3.3, '*Management and governance failings in practice*'.

1.5.3 Risk management framework

86. A key feature of HBOS's failure was that the internal controls within its operating divisions, in particular its Corporate and International Divisions, were ineffective and did not keep pace with the rapid growth that these divisions experienced. The FSA's Enforcement Final Notices issued to Bank of Scotland plc and Peter Cummings highlighted a number of core control issues relating to the Corporate Division, including:

- there was no process for defining risk appetite, beyond high-level industry sector limits, and these were not used effectively to constrain growth;
- risk management was regarded as a constraint on the business rather than integral to it;
- individual sanctioning decisions were made without a detailed consideration of the impact on the wider portfolio; and

(11) James Crosby became Sir James Crosby in June 2006 but relinquished this title in June 2013.

- a significant part of the portfolio had not been risk-rated or ratings were out of date.

87. Within the International Division, the risks attached to rapid growth were consistently highlighted, but generally do not appear to have led to any significant restraint in the division's plans. Representations indicated a difference of view (which the Review was unable to resolve through contemporaneous documents) as to the respective roles and responsibilities of the division's UK-based and local operations, in particular with regard to the carrying out of credit sanctioning assessments.

88. The impact of these deficiencies at divisional level was exacerbated by the ineffectiveness of the firm's Group control functions. The effectiveness of the firm's Group Risk function was hampered by personnel and structural changes. Challenge from Group Internal Audit was limited, with some evidence that internal audit reports could be upgraded based on promises from the business to make improvements. The Audit Committee and the Corporate and International divisional Risk Control Committees did not provide effective challenge on issues that were brought to their attention.

89. The Board delegated responsibility for the firm's overall systems and controls to the Group CEO.

90. HBOS's risk management framework is considered further in Part 3, Section 3.4, '*Failings in the implementation of the risk management framework*'.

1.5.4 Risk culture

91. The ineffectiveness of HBOS's risk management framework was a consequence of a culture within the firm that prioritised growth aspirations over the consideration of risk. HBOS's weak risk culture was evident at all levels of the firm, with the Board-approved emphasis on growth setting the tone for the rest of the organisation.

92. The early success of HBOS in the benign economic conditions prior to the crisis also led to complacency during the crisis. For example, some members of the HBOS Board expressed confidence in the strength of the firm's balance sheet and viewed the economic downturn as an opportunity to grow, even though they were aware of weaknesses in the firm's credit risk management capability and its overreliance on wholesale funding.

93. HBOS's risk culture is considered further in Part 3, Section 3.3, '*Management and governance failings in practice*'.

1

1.6 FSA supervision

1.6.1 A deficient regulatory approach

94. Consistent with the findings of *The RBS Report*, the failings of the FSA in relation to HBOS were primarily due to deficiencies in the FSA's prevailing approach to the supervision of systemically important firms, which the FSA Board and Executive Committee (ExCo) did not adequately challenge or review.

95. FSA senior management[12] adopted an approach to supervision which entailed placing heavy reliance on a firm's senior management and control functions. The FSA did not see its role as being to criticise a firm's business model in case it was perceived to be acting as a 'shadow director'.

96. This approach gave rise to a supervisory framework with:

- inadequate resources devoted to the prudential regulation of large systemically important banks;
- inadequate focus on the core prudential risk areas of asset quality and liquidity in an apparently benign economic outlook;
- inadequate consideration of strategic and business model related risks, including the adequacy of capital buffers; and
- a risk-assessment process that was too reactive.

97. Despite the FSA's prudential responsibility for systemically important firms and as noted in *The RBS Report*, the FSA Board did not play any operational role in decisions relating to the supervision of specific firms. The Board did, though, receive briefings on current issues – including major firm-specific issues – from executive management and so was in a position to ask questions and challenge assumptions. However, no prudential issues were raised in relation to HBOS in the pre-crisis period in board reports.

98. Members of ExCo had very little proactive engagement with retail firms or their supervision teams, unless there was crystallised risk. Furthermore, in the pre-crisis period, while ExCo did have high-level discussions about resourcing and priorities, it neither had in-depth discussions, nor received detailed management information, about specific aspects of the operating model, such as the supervisory resource per firm or the balance of work between conduct and prudential issues.

99. Overall, the FSA's approach was too trusting of firms' management and insufficiently challenging. The FSA executive management, led by CEO Mr John Tiner, designed (or failed to redesign) this deficient approach to supervision. Further, the oversight of the executive by the FSA Board, led by the Chairman Sir Callum McCarthy[13], was insufficient. As the Managing

(12) FSA 'senior management' refers to Head of Department level up to Managing Director.
(13) Callum McCarthy became Sir Callum McCarthy in June 2005 and is referred to throughout the Report as Sir Callum.

Director of Retail Markets and a member of the FSA Board and ExCo from June 2004 until April 2008, Mr Clive Briault was responsible for the strategy and performance of the business unit that supervised HBOS for the majority of the Review Period.

100. It is now clear that the FSA's pre-crisis(14) approach to prudential supervision was not appropriate for the purpose of meeting its market confidence objective. However, the FSA was responsible for a broad range of financial regulation issues and was expected to regulate within established global standards. There was also a sustained political emphasis on the need for the FSA to be 'light touch' in its approach and mindful of the United Kingdom's competitive position.

101. Within this context, it was inherently unlikely that senior leaders of the FSA would have proposed, before the first signs of the crisis (for example, before summer 2007), a supervisory approach which entailed higher capital and liquidity requirements, supervisory caps on rapid bank balance sheet growth, or intensive analysis of asset quality. If they had, it is likely that their proposals would have been met by extensive complaints that the FSA was pursuing a heavy-handed, gold plating approach which would harm the United Kingdom's competitiveness.

102. The FSA's regulatory approach is considered in more detail in Part 4, Section 4.2, '*The FSA's philosophy and approach to supervision*'.

1.6.2 Supervision of HBOS in the pre-crisis period

103. In the years prior to the crisis, the FSA had identified a number of key risks which ultimately contributed to the failure of HBOS. These included: the need for strong Group control functions to counterbalance the federal structure; the risks within the CRE book; the atypical credit approval processes in Corporate; a lack of technical expertise at a senior level in Group Risk; the significant reliance on wholesale funding; and that the control framework was not appropriate to support the rapid growth overseas.

104. The FSA's early focus on the adequacy of HBOS's risk management framework included the commissioning of an independent Skilled Persons Report by PwC in 2004. However, this early focus was not sustained with sufficient intensity throughout the Review Period, as priorities shifted and apparent progress was made by the firm to address the risks.

105. A core judgement made by the HBOS supervision team(15) from late 2005 was that HBOS's overall control framework was good and that the firm had an 'open and cooperative' relationship with the FSA. Indeed, the relationship was generally seen as better than the FSA had with most of HBOS's peers. This judgement, together with the benign economic outlook and resource constraints, had implications for the intensity with which HBOS was supervised, with much reliance being put on HBOS's senior management and control functions.

106. For a significant portion of the Review Period, Mr Crosby was both HBOS Chief Executive and a member of the FSA board. However, the Review found no evidence that Mr Crosby exercised any undue influence as a member of the FSA Board or its committees on the decisions of the FSA in relation to the supervision of HBOS.

107. The supervision team prioritised FSA priorities, such as Basel II implementation and the 'Treating Customers Fairly' (TCF) initiative, together with reactive work in areas where there was crystallised risk or high-profile conduct issues. It was not until after the failure of Northern Rock

(14) For the purposes of this Report, the failure of Northern Rock in September 2007 is defined as the start of the crisis period.
(15) The 'supervision team' refers throughout this report to the FSA team, led by a relationship manager, responsible for the supervision of HBOS.

in September 2007 that prudential issues such as liquidity became the highest priority. However, by this time it was too late to prevent the failure of HBOS.

108. While the resourcing level on the supervision team was broadly in line with the FSA's prevailing approach to a firm of this kind, the team experienced an unusually high volume of turnover, which included three changes of manager during the Review Period. This created a lack of continuity and made it more difficult for supervisors to identify patterns of behaviour and emerging risks over time.

109. Although the supervision team escalated key issues and judgements, FSA senior management were distant from day-to-day supervision. Senior management did not provide sufficiently clear direction to front-line supervisors, track progress or monitor issues over time. Further, consistent with the FSA's approach at the time, key interactions with HBOS were primarily led by the supervision team rather than at a more senior level. This undermined the FSA's credibility when challenging senior management and too much responsibility for identifying and mitigating problems was delegated to too junior a level.

110. A divisional initiative launched by Major Retail Groups Division (MRGD) senior management in late 2005 resulted in a number of items being removed from HBOS's Risk Mitigation Programme (RMP), which was the supervision team's only formal tracking framework of actions to address identified risks. The initiative was intended to make the best use of limited supervisory resource by ensuring supervision teams focused on those issues which were considered to pose the greatest risk to the FSA's objectives. While the supervision team continued to meet regularly with HBOS to discuss progress on these issues, the pace of remediation of issues appears to have slowed. This initiative also led to even greater reliance being placed on HBOS senior management and Group control functions to confirm that issues had been addressed, with limited testing carried out by the FSA.

111. The FSA was the consolidated regulatory authority for the HBOS Group. But it placed a considerable amount of reliance on local regulatory authorities, as well as the firm's Group Risk function, to provide oversight of HBOS's International businesses. This posed a challenge to effective supervision of the entire HBOS Group by the FSA and gave rise to a risk of underlap. In the case of HBOS's corporate lending business in Australia, it appears that there was a lack of clarity within the FSA supervision team as to the limits of the oversight provided by the Australian Prudential Regulatory Authority (APRA).

112. The supervision team suffered from a lack of continuity, experience and senior FSA management engagement. A more experienced, stable and better-supported supervision team might have been more sceptical about the effectiveness of the relationship with HBOS senior management given its knowledge of issues at the firm at the time. Had it been more sceptical, it might have taken a number of actions to address weaknesses in the pre-crisis period, including:

- questioning the amount of reliance that could be placed on HBOS's control functions and undertaking a follow-up review on the effectiveness of risk management;
- considering taking steps to restrict HBOS's asset growth, being aware of the firm's increasing reliance on wholesale funding;
- following through effectively on concerns raised about the control framework in International;
- pressing Corporate to take a more rigorous approach to the risk profile of its CRE exposures following a 2005 stress-testing exercise;
- questioning whether the difficulties Corporate had with Basel II implementation were indicative of wider failings in risk management; and

- recognising the importance of HBOS having a board constitution that more strongly reflected the evolving business risk profile.

113. A more probing, sceptical and interventionist stance in the pre-crisis period could have delivered different outcomes but this would have required a significant increase in the resources and experience of the team, together with a different approach to supervision and the active support of FSA executive management and the Board.

114. The FSA's supervision of HBOS in the pre-crisis period is considered further in Part 4: Section 4.3, '*Prudential supervision of HBOS*'; Section 4.4, '*Supervisory approach to asset quality*'; Section 4.5, '*Supervisory approach to liquidity and Treasury asset quality*'; Section 4.6, '*Supervisory approach to capital and Basel II implementation*'; and Section 4.7, '*Supervisory approach to management, governance, culture and control functions*'.

1.6.3 Supervisory response to the deteriorating economic environment

115. The FSA took action quickly after the failure of Northern Rock, in September 2007, to review the position of the most vulnerable firms whose business models bore most similarity to that of Northern Rock. This marked the start of FSA contingency planning work.

116. Throughout the contingency planning period, in particular from March 2008, there was an unprecedented level of FSA senior management involvement in the supervision of HBOS, including by the FSA Chairman, Sir Callum, and Chief Executive, Sir Hector Sants.(16)

117. With greater support and direction from FSA senior management, the supervision team prioritised prudential issues following the onset of the crisis. In August 2007, HBOS was identified as one of a number of firms that were particularly vulnerable to market disruption. There was heightened supervisory focus on HBOS's funding and liquidity from this point. However, despite the fact that HBOS was a peer outlier in terms of its reliance on wholesale funding, the FSA did not focus on it as a bank with a prospect of failure until March 2008.

118. Greater action by the FSA, and HBOS, in the period from August 2007 to February 2008 could arguably have helped to reduce the cost of failure. However, the possibility that HBOS could fail was still seen as remote during this period. Within the context of what was seen at that time to be a temporary dislocation in the financial markets, HBOS appeared to be weathering the early storm reasonably well following steps taken in August and September 2007 to renew its wholesale funding.

119. Contingency planning work on HBOS intensified from March 2008 in response to a number of significant market events which led to a further tightening of liquidity in financial markets. This period also marked the start of activity by the Tripartite authorities on various generic bank measures, including the need for more capital and the provision of additional funding through the establishment of the SLS.

120. On balance, given the circumstances in which the FSA found itself at the beginning of the contingency planning period, the difficult judgements taken by the FSA during this period, as it tried to contain the consequences of the crisis for multiple firms that were at risk of failure, were largely sound. It is unlikely any steps that the firm or the FSA could have taken during the contingency planning period would have fundamentally changed the outcome of failure.

(16) Hector Sants became Sir Hector Sants in December 2012 and is referred to throughout the Report as Sir Hector.

121. The FSA's supervision of HBOS after the onset of the crisis is considered further in Part 4, Section 4.8, '*Contingency planning*'.

1.7 Recommendations

1.7.1 Changes to the regulatory framework and approach

122. Since the events described in this Review, much of the regulatory landscape governing the UK financial services sector has changed. Previous reviews conducted by HM Treasury, the Bank of England, the FSA and the PCBS have all contributed to these changes. Collectively, these changes have addressed many of the failings identified in this Report. Key changes to the regulatory framework in the United Kingdom include:

- the move to a 'twin peaks' regulatory structure where conduct and prudential supervision of banks are undertaken by different regulators, the FCA and PRA respectively;
- clearer and more focused statutory objectives which refer to effective competition rather than the competitiveness of the United Kingdom;
- the creation of the Financial Policy Committee (FPC) charged with identifying, monitoring and taking action to remove or reduce systemic risks;
- the adoption by the Bank of England of the integration of macro and micro-prudential supervision as a core element of its strategy; and
- the introduction of the Senior Managers and Certification Regimes governing the conduct of individual bankers.

123. Significant regulatory change has taken place on an international level, led by the Financial Stability Board and Basel Committee on Banking Supervision, in particular:

- the introduction of more robust capital and liquidity standards for banks by Basel III (see Part 2, Sections 2.8.6, '*The Basel III liquidity regime: would it have reduced the liquidity risk?*'; and 2.9.7, '*Basel III estimates*');
- the forward-looking, judgment-based approach to the supervision of firms which are viewed as domestically or globally systemic, which is also supported by greater resources, and a suite of analytical tools such as stress testing;
- requirements for recovery and resolution plans; and
- requirements to hold minimum levels of loss-absorbing capacity, and powers to 'bail-in' certain types of debt.

124. Other relevant changes to the broader regulatory landscape affecting UK banks include:

- significant developments in UK corporate governance standards, and in particular expectations of boards of directors and control functions, following the publication of The Walker Report, *A review of corporate governance in UK banks and other financial industry entities* in November 2009; and

- changes to International Financial Reporting Standards, which will introduce a new 'expected loss' model for impaired loan provisioning from January 2018.

125. While these changes should serve to mitigate the risks of costly failures of firms such as HBOS occurring in future, much will depend on how the new structures and standards introduced are implemented in practice. Section 1.7.2 below sets out some recommendations for firms and regulators, arising from failings identified in this Report, that warrant further attention.

1.7.2 Recommendations for firms

Management, governance and culture – Board responsibility

126. HBOS's business model was inherently vulnerable to an economic downturn or a dislocation in wholesale funding markets. This was the product of a flawed strategy which was implemented without due regard to basic standards of banking and risk management. Every member of a bank's Board of Directors must take responsibility as part of a collective for ensuring that its business model is sustainable and that the principle of safety and soundness is embedded in the organisation's culture; and directors who hold roles under the Senior Managers Regime will have specific accountabilities within this.

Board composition

127. A feature of the HBOS Board was its lack of knowledge and experience of banking, which hindered its ability to challenge the firm's Corporate and International Divisions effectively. A bank's Board of Directors should include non-executives with a diversity of experience, from inside and outside the banking sector. Moreover they must, between them, have the capacity and motivation to explore and challenge key business issues rigorously with the executives.

Senior management relationships with regulators

128. While the Senior Managers Regime will clarify accountabilities within a bank, it is vital that persons approved under this regime take ownership of their regulatory responsibilities and for executives to establish within their business areas a culture that supports adherence to both the spirit and letter of relevant requirements. They should proactively seek to identify threats to the firm's safety and soundness, and notify regulatory authorities where issues arise – not simply assume that risk management systems are adequate if regulators do not intervene.

1.7.3 Recommendations for regulators

Will to act

129. The PRA and FCA have both adopted forward-looking and judgement-led approaches to supervision in seeking to meet their statutory objectives. While it is not the role of the regulators to ensure that no bank fails, where the risks to their objectives are high they have statutory powers to intervene, for example to require a bank to change its business model. Where intervention is warranted, the regulators must be willing and able to do so free from undue influence, in particular when markets are benign and in the face of changing public policy priorities.

Supervision of international groups

130. A significant proportion of HBOS's balance sheet was derived from its overseas operations which grew rapidly during the Review Period, in particular in Australia and Ireland. While it is necessary for UK regulators of a consolidated international group to place reliance on local regulatory authorities, the UK regulators should understand the scope of the oversight provided by the local regulator in determining the extent of that reliance. UK regulators should also have the level of understanding of the international businesses to be able to engage effectively with the firm and the local regulators as consolidated supervisor.

Conflicts of interest

131. UK financial services regulators should also guard against the risks of actual or perceived conflicts of interest arising from the composition of their Boards. The Review found no evidence that Mr Crosby exercised undue influence over the supervision of HBOS from his position as a member of the FSA's Board. However, relevant regulatory authorities should review their conflicts of interest policies to ensure that the risks associated with including serving industry practitioners as non-executive directors on their Boards are adequately managed.

Part 2
How did HBOS fail?

2

2.1 Introduction

132. On 1 October 2008, HBOS was approaching a point at which it was no longer able to meet claims as they fell due and sought Emergency Liquidity Assistance (ELA) from the Bank of England. The loss of liquidity in large part reflected underlying concerns about the quality of the Group's assets and its solvency.

133. Part 2 seeks to explain how the decisions of the Board and other events affected HBOS and caused it to fail. However, many of the risk features of the HBOS business model were also evident to external parties at the time. Therefore, another striking feature of the firm's failure is the fact that none of the established market mechanisms for external scrutiny prevented the failure.

134. The Review Period is the focus of Part 2, but it is likely that some of the decisions taken by the firm and events that influenced the failure had their origins prior to the Review Period. Therefore, Part 2 also includes a summary of the development of HBOS from the merger of Bank of Scotland (BoS) and Halifax in 2001 to the start of the Review Period. Similarly, Part 2 includes a summary of the losses reported by HBOS after the Review Period, as these were a further outcome of decisions and events during the Review Period.

135. Part 2 contains:

- an overview of the external market environment (Section 2.2), including a description of the macroeconomic environment in which HBOS operated;
- an overview of the HBOS Group (Section 2.3), including the merger of the Halifax and BoS in 2001 that created HBOS, a summary of the business and strategies that HBOS pursued during the Review Period, and the outcome of those strategies;
- consideration of the asset quality of the different HBOS divisions and the subsequent losses that arose on those assets: Section 2.4 (Corporate Division), Section 2.5 (International Division), Section 2.6 (Retail Division), and Section 2.7 (Treasury Division);
- consideration of the liquidity and wholesale funding, and capital positions of HBOS: Sections 2.8 and 2.9 respectively;
- a summary of the market's view of HBOS and how it hardened against the firm in the latter part of the Review Period (Section 2.10); and
- a summary of HBOS's financial reporting, particularly in 2008 as impairment losses increased (Section 2.11).

136. This Part does not examine the Insurance and Investment Division of HBOS or HBOS's investment in Sainsbury's Bank. This is because the performance of these areas did not materially contribute to the failure of HBOS. The impact of losses attributable to fines and redress of conduct failings by HBOS has been noted but this Part does not consider HBOS's conduct in dealing with its customers more broadly, as the failure of HBOS was a prudential failure.

137. We have inevitably applied hindsight in forming our views. In doing so, we do not automatically imply any wrongdoing on the part of HBOS or those involved by reference to the standards of the time and we are not suggesting that what is clear in hindsight was clear to those involved at the time. We have made it clear where we have concluded that HBOS was an outlier or we judge that decisions made were poor by the standards at the time.

2

2.2 Overview of the external market environment

2.2.1 Introduction

138. The causes and origins of the financial crisis in the late 2000s have been extensively analysed elsewhere. This section briefly summarises key factors that contributed to the development of the crisis and were of direct relevance to HBOS's failure. As such, it draws on other reports, such as *The Turner Review – A regulatory response to the global banking crisis*, as well as making use of publications produced during the period, including the Bank of England's *Financial Stability Report*(17) (FSR) and the Financial Services Authority's (FSA) *Financial Risk Outlook (FRO)*.

2.2.2 Growing vulnerabilities

New economic paradigm

139. From 2001 until 2007, economic growth in the major economies was relatively robust, giving rise to increasing confidence among lenders about the medium-term outlook for the global economy.

140. The UK economy showed comparable trends to that of the global economy as a whole, and to a certain extent outperformed the latter (Chart 2.1). Indeed, UK domestic economic growth had been relatively steady since the recession of the early 1990s, resulting in an extraordinarily long period (around 60 quarters) of continuous expansion. The growth in the financial services sector was more than twice as fast, averaging 6% per annum in the decade preceding the financial crisis, and increasing its share of nominal gross domestic product (GDP) to around 10%. Confidence in the future prospects of the economy was reflected in both bank and non-bank equity prices, which rose steadily from the start of 2003 until 2007 (Chart 2.2).

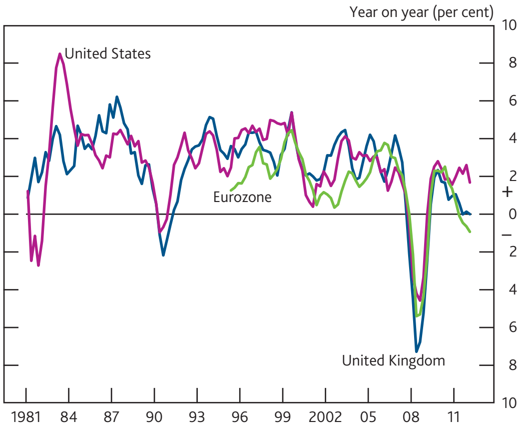
Savings imbalances and the search for yield

141. Global and domestic structural imbalances had however started to develop in the seemingly benign economic context. A number of nations such as China, Japan and Germany accumulated significant current account surpluses during this period, driven by high domestic saving rates and exports exceeding imports. At the same time, countries such as the United States, United Kingdom, Ireland and Spain built up large deficits as consumption of imported goods rose.

142. Surplus savings of the creditor countries were re-invested in low-risk assets in debtor countries, such as government bonds, which led to a significant reduction in real interest rates (Chart 2.3).

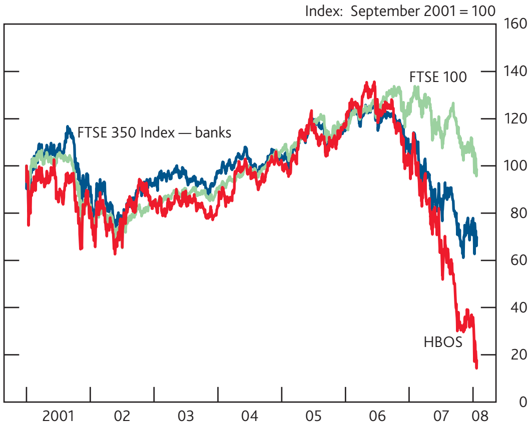
(17) Prior to 2006 the Bank of England's *Financial Stability Report* was called the *Financial Stability Review*.

Chart 2.1: Major economies' real gross domestic product annualised growth rates[(a)]



(a) Source: Thomson Reuters DataStream (Eurostat, ONS, US Bureau of Economic Analysis).

Chart 2.2: Relative share price performance, 2001 – 08[(a)]



(a) Source: Bloomberg.

2

Development of asset bubbles

143. With real and nominal interest rates decreasing, investors sought riskier, higher-yielding assets in order to maintain nominal returns. Falling interest rates also reduced the discount rate for valuing assets, pushing up their prices. Rising collateral values in turn fuelled consumer spending and encouraged higher borrowing and indebtedness, especially to purchase property, resulting in even higher assets prices and a diminished perception of the risks of debt. It was also increasingly assumed that low inflation would persist, so keeping interest rates and debt servicing costs down.

144. Property prices across a range of countries rose rapidly during this period. In the United Kingdom, house prices rose every year from 1995 to 2007 (Chart 2.4) at a rate significantly above that of income growth. With strong economic growth and low unemployment meaning that repossessions and losses remained low, rising property prices contributed to a perception that lending to the housing market was very low risk over the longer term.

145. Banks with longstanding mortgage portfolios were able to use the loans written at the beginning of the expansionary period to support the quality of their overall portfolios. The rapid rise in house prices quickly reduced loan to values (LTVs: the value of the loan relative to the value of the property providing security for the loan). On the basis of low portfolio average LTVs there appeared to be adequate cover in the event of borrower default. The banks' ability to borrow cheaply from wholesale money markets also increased the supply of funding into the property market and pushed house prices up even higher.

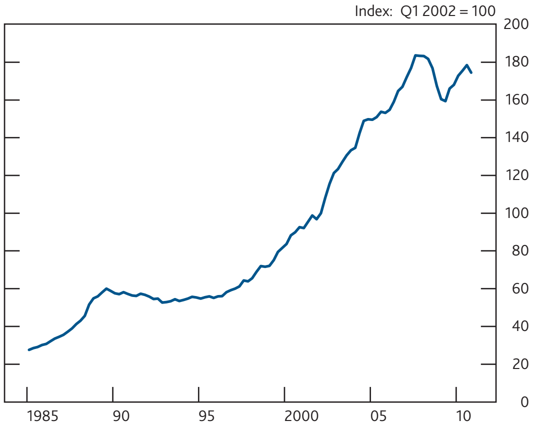
146. Competition in the UK mortgage market had become increasingly intense since the deregulation of the 1980s and subsequent demutualisation of many larger building societies, which led to margins on mortgage products being compressed. This incentivised firms to enter markets where returns appeared more attractive, such as specialist mortgage lending and commercial real estate – sectors which were inherently riskier but viable if products were priced correctly. Inappropriate pricing, however, meant that return on risk decreased, leading firms to generate and retain insufficient profits and capital to cover the consequential losses.

2

Chart 2.3: Sterling real interest rate trends, 1985 – 2011[(a),(b)]

(a) Source: Bloomberg and Bank of England calculations.
(b) Five year, five year forward rate, based on indexed linked Government bonds.

Chart 2.4: UK house price index[(a)]



(a) Source: ONS.

147. Business models based on secured lending increasingly became less robust than they appeared. A combination of higher borrowing and stagnant real household income levels led to a rapid increase in UK household income gearing, reaching around 170% of post-tax income in 2008 (Chart 2.5). An explanation of this growth is the increase in the availability of financial services to the broader economy, but the sharp upward movement in debt leading up to the financial crisis also suggested increasing vulnerability among households to a downturn in credit conditions.

148. The size of the UK commercial property market is hard to assess but according to the De Montfort University survey[(18)] outstanding debt and equity was over £200 billion[(19)] at the end of 2007, having grown over fourfold since 1999. It was also a relatively concentrated lending market being dominated by a small number of, predominantly, UK banks.[(20)]

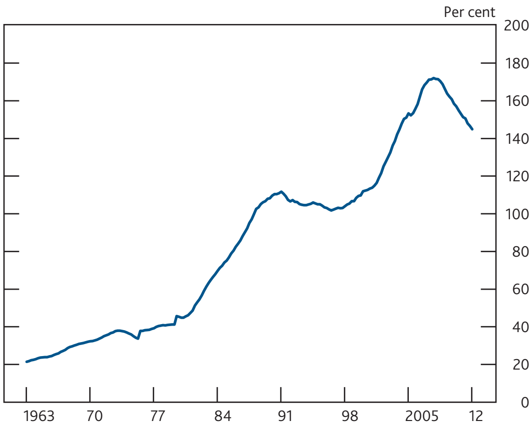
149. The UK commercial property sector has had a turbulent history. In the past 40 years there have been significant price rises followed by dramatic falls in the early 1970s and 1990s, as well as in the more recent financial crisis, with each period associated with a large build up in lending followed by de-leveraging. Some of these episodes have also been associated with wider financial system stress. Fortunes in the sector can rapidly reverse, affecting a large number of market participants. The proportion of quoted property companies making a loss rose from zero to almost 30% between 1988 and 1992[(21)] and 25 banks failed or closed down as the market turned.[(22)]

150. The De Montfort survey indicates that the period from 1999 to 2003 was characterised by rising interest margins, generally falling LTV ratios (with the exception of prime retail and offices), rising arrangement fees and increasing income-to-interest cover.

151. The period between 2003 and 2006/07 saw a reversal of these trends with margins falling and LTV ratios rising. Commercial property values (as measured by the Investment Property Databank (IPD) Index) reached their peak in June 2007 (Chart 2.6), having risen since the late 1990s. Borrowers took advantage of the search for yield, increased competition and the seemingly inexorable rise in property values to refinance deals on average every three to four years.

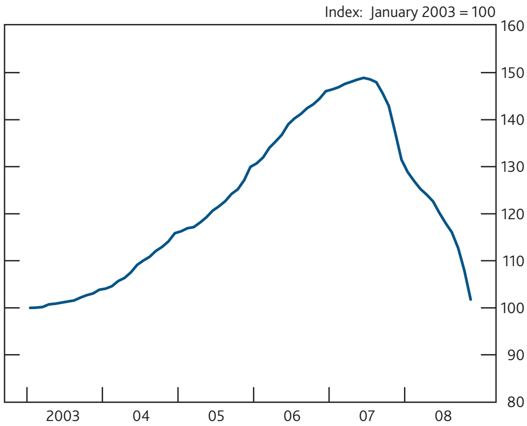
(18) De Montfort University: The Commercial Property Lending Market Research Report, a twice yearly survey of commercial property lending in the UK.
(19) Equity was £3.5 billion of the total.
(20) The six largest lenders had consistently held 50% to 60% of the outstanding debt, while the twelve largest lenders had around 75% of the outstanding debt; UK banks represented around 70% of lending, with Irish and German banks being the other main lenders.
(21) Bank of England *Quarterly Bulletin*, 2007 Q1.
(22) Bank of England *Quarterly Bulletin*, 2013 Q1.

Chart 2.5: UK household debt as a percentage of income(a)



(a) Source: ONS and Bank of England calculations.

Chart 2.6: UK commercial property price index(a)



(a) Source: MSCI and Review calculations.

152. The high point was in 2006/07, after the average rental yield on property fell below the cost of funding (as approximated by the five-year swap rate) in 2006.

Growing reliance on wholesale funding and leverage

153. Another important trend in the pre-crisis years was the rapidly expanding role of global financial markets in the financial intermediation process and the growth of the shadow banking system.[23]

154. Companies, particularly in the United States, were increasingly able to access funds directly on the bond market, thereby reducing their need to use banks as intermediaries. This led banks to seek new sources of revenues.

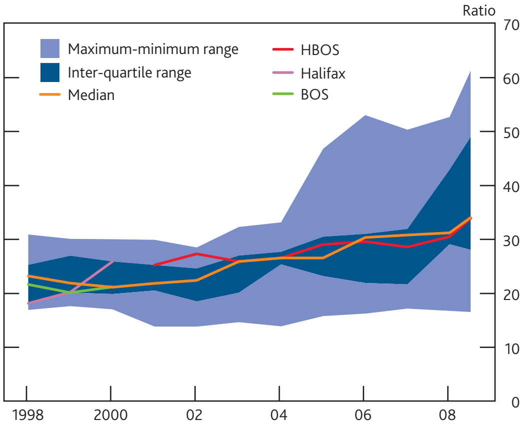
155. Further, with household savings ratios declining in a number of countries, including the United Kingdom, banks also had to rely more heavily on wholesale borrowing to expand lending. Securitising packages of loans and selling them on to wholesale investors quickly became an important and cheaper way for banks to raise funds for new lending. It also created new dependencies, however, with securitising vehicles requiring liquidity commitments from their bank sponsors. Securitisations using master trusts also required the originator to be able to replenish or top up the asset pool, meaning the originator had to be capable of continued lending, while strengthening its obligations to the securitisation structure.

156. With cheaper funding available from wholesale markets and senior bank management given financial incentives to meet return-on-equity targets (ROE), banks began to increase their leverage[24] (Chart 2.7).

157. Increased financial sophistication, innovation and the desire for enhanced yield, often through leverage, led to the development of more complex financial products aimed at meeting investor demands, such as structured credit and credit derivatives. Many of these had property loans as underlying assets. While the growth of these products was originally seen as an advantage, in that it enabled firms to distribute risk more effectively, this belied difficulties in accurately valuing the products due to opacity of the underlying loans and weaknesses in the complex models used.

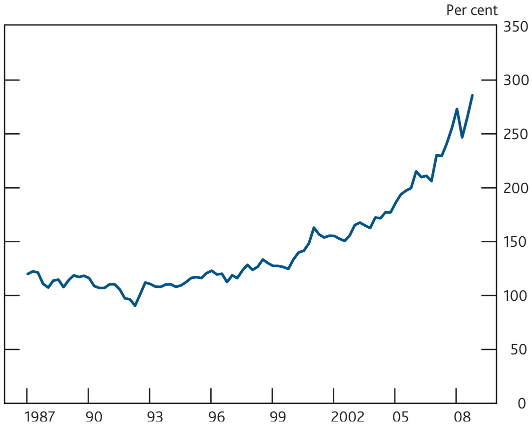
(23) The Financial Stability Board defines 'shadow banking' as credit intermediation involving entities and activities outside the regular banking sector.
(24) Shareholders relied heavily on ROE, i.e. net income as a percentage of shareholders' equity, as a measure to determine the success of banks. Furthermore, remuneration of senior management was greatly influenced by ROE achieved.

Chart 2.7: Major UK banks' leverage(a),(b)



(a) Source: *Annual Reports and Accounts* and Bank of England calculations.
(b) Total assets divided by total equity excluding minority interests.

Chart 2.8: Gross external debt of UK monetary financial institutions as a percentage of GDP(a)



(a) Source: ONS and Bank of England calculations.

158. A further trend in financial markets was the increased globalisation of financial activity. UK firms were key participants, borrowing and lending heavily in global wholesale markets, with rapidly increasing levels of foreign borrowing (Chart 2.8) helping to fuel the rapid expansion of credit in the United Kingdom.

159. The rapid growth in cross-border borrowing made UK banks more vulnerable to developments and changes in sentiment in other countries. Many buyers of UK residential mortgage-backed securities, for example, were foreign institutions.

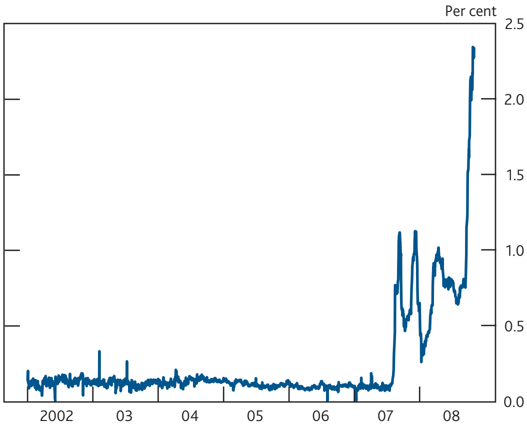
160. With a significant proportion of banks' funding coming from other financial institutions; shadow banks in turn dependent on liquidity support from banks; high system leverage; and chains of interdependencies created by complex financial products; linkages between financial institutions inevitably grew. The opacity of the system also grew and thus the ability of individual institutions and regulators to identify and assess the build-up of risks declined. This increased the risk that problems or concerns in one part of the global financial system could be rapidly transmitted to another part of the system, and then transmitted on again, and again.

2.2.3 The onset of the financial crisis

161. The apparently strong position of the global economy for much of the 2000s led to increased confidence about the economic outlook, but it also contributed to growing vulnerabilities in the global financial system, due to a search for yield, greater leverage by banks and borrowers, increasing complexity in financial products and a high level of interconnectedness.

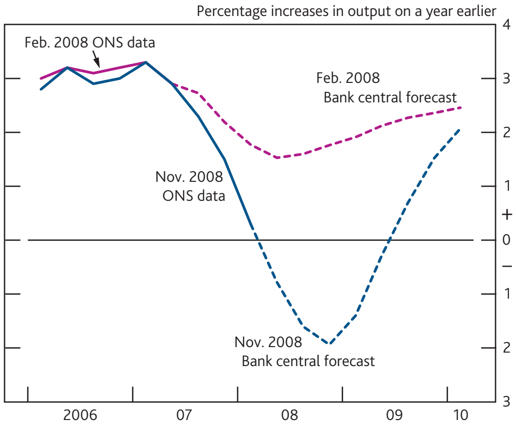
162. These vulnerabilities first materialised in the United States in 2006. With US interest rates rising from historically low levels, defaults by sub-prime mortgage borrowers had begun to increase, with attendant effects on the values of securitisation structures that held these assets.

Chart 2.9: LIBOR-OIS sterling three-month spread(a)



(a) Source: Bloomberg.

Chart 2.10: Bank of England growth projections, February 2008 and November 2008(a),(b)



(a) Source: Bank of England and ONS.
(b) Forecasts are mean GDP growth projections based on Bank estimates of past growth and market interest rate expectations.

163. Strains spread further during summer 2007 when two Bear Stearns hedge funds effectively collapsed in July, shortly followed by the suspension of withdrawals from three investment funds managed by BNP Paribas. There was a significant reduction of global interbank liquidity as investors grew concerned about counterparties' exposures to bad debts and to each other, and liquidity risks arising from the shadow banking sector crystallised for banks. Funding for second tier banks dried up, resulting in Northern Rock seeking ELA from the Bank of England in September and experiencing a retail run. There were substantial falls in the share prices of other mortgage banks.

164. The spread between three-month London Interbank Offered Rate (LIBOR) and Overnight Indexed Swap (OIS) rates first widened substantially in August 2007 highlighting unprecedented perceived levels of credit risk in banks (Chart 2.9).(25)

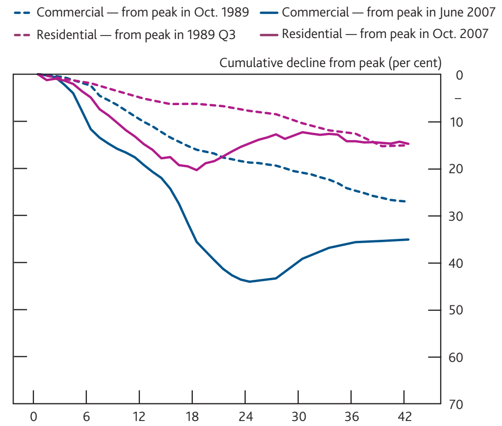
165. Through late 2007 and early 2008, many firms experienced severe mark-to-market losses in trading books as volatility increased and asset prices fell.

166. As 2008 progressed, the functioning of financial markets deteriorated further and funding problems at many banks continued to grow. Stresses led to the failure and publicly supported rescue of Bear Stearns in March. Matters came to a head in September: the outright failure of Lehman Brothers ended the confidence that major institutions were 'too big to fail'; AIG was rescued; and retail deposit runs led to bank failures (e.g. Bradford & Bingley and Icelandic banks). There was an almost total seizure of interbank money markets, a second large unprecedented jump in the LIBOR-OIS spread, and banks became significantly reliant upon central bank support.

167. In the UK real economy, conditions had started to weaken in late 2007, with commercial real estate prices registering their first quarter-on-quarter fall since 2001 in 2007 Q3 and house prices starting to decline in 2007 Q4. But the initial change in economic conditions was not marked, and the Bank of England's *Inflation Report* projections in February 2008 indicated only a negligible chance of a recession over the following two years, albeit there was potential for very low growth (Chart 2.10). By late 2008, however, UK economic projections were dramatically worse, with a severe recessionary period expected, driven by a sharp contraction in the supply of lending to the real economy.

(25) While problems have subsequently been found regarding banks' reporting of LIBOR, the metric is nonetheless useful in examining relative perceptions of banks' riskiness through the Review Period.

Chart 2.11: UK property price falls in recent recessions[a]



(a) Source: Halifax, MSCI, Nationwide, Thomson Reuters Datastream and Bank of England calculations.

168. In the housing market, prices declined sharply in 2008 as banks tightened lending criteria. The fact that this did not lead to a complete collapse in residential property values or a large increase in impairments was largely because of the rapid and large cuts in the official Bank Rate by the Bank of England, employment remaining resilient and shortages to the supply side of the housing market. It did, however, contribute to declining confidence in the business models of financial firms that were heavily exposed to the residential real estate sector.

169. The UK commercial property sector was to be even more severely affected by the recession. As the financial crisis took hold, commercial property prices fell much more sharply than residential property prices and stayed low (Chart 2.11) so that, while the value of residential property in 2012 remained more than two and a half times mid-1990s levels, commercial property prices were barely higher than those 18 years previously.

Box 2.1: The outlook of the authorities through the Review Period

While the scale and severity of the financial crisis was not anticipated by its participants, during the Review Period the authorities had highlighted some emerging risks, particularly the growth of commercial property and household debt, financial interconnectedness and liquidity, in their communications. However, in the absence of a formal macro-prudential regime and a more activist climate of regulation, such communication had little apparent effect on the behaviour of firms and markets until it was too late:

- The Bank of England's June 2005 *FSR*, for example, discussed: increasing credit risk arising from increased household debt to income and the rapid growth in banks' commercial real estate lending; a search for yield leading to increased leverage, loosening covenants and increased holdings in illiquid assets; and increased reliance on wholesale funding.

- The December 2005 *FSR* stated that *'The UK financial system remains healthy. Near-term risks to stability from the domestic economic environment and from conditions in global financial markets seem limited'.* Discussing stress testing of banks, it reported that *'even the "worst case" scenario…costs the banking sector just 0.35% of total assets. Such losses would have to increase substantially before they posed concerns for financial stability'*. Despite this, the report stated continued concern about the issues identified previously, as well as highlighting potential losses resulting from securitisations held on balance sheet. In a speech published within the FSR, Sir Andrew Large (a former Deputy Governor of the Bank of England) asked: *'are vulnerabilities mounting, and will they one day crystallise when a bigger shock arrives that the market simply cannot absorb? The fact is, we just don't know. And that is why we need to be particularly vigilant and to think through the implications'*.

- The July 2006 *FSR* argued that risks in the system had increased and set out the principal issues as being: low risk premia; global financial imbalances; rapid leveraging by corporates (particularly in commercial property); high household indebtedness; the growing size and impact of globally significant financial institutions; and the dependence of financial institutions on market infrastructure – all of which had a role to play in the subsequent crisis.

- The *FSR* maintained a similar framework in April 2007 and stated that there had been *'an edging up of aggregate risk to the UK financial system'*. Following the failure of Northern Rock in September 2007, the October 2007 *FSR* placed an increased emphasis on liquidity risk, although its assessment of major bank solvency under stress had not changed significantly from previous analysis. It suggested that banks needed to consider more severe liquidity risk scenarios, as well as further improve their solvency stress testing capabilities.

During the Review Period, the FSA published its *FRO* on an annual basis. The *FRO* had a broad remit, covering both prudential and conduct risks for all of the key financial sectors in the economy:

- The 2005 *FRO* noted that economic growth was expected to remain strong, though this would in time slow to be more in line with long-term trends. In terms of sectoral issues for UK banks and building societies, it noted that while corporate credit quality was good, gearing was at historical highs, creating vulnerabilities to shocks; further, there was a risk of a fall in commercial property prices, though this was considered lower risk compared to the 1990s.

- The outlook for 2006 continued to be fairly benign, with the central scenario being one of continued economic and financial stability in the short term. However, the *FRO* noted some signs of a deteriorating environment, including slowing growth, rising liquidations and high leverage. It focused particularly on the retail market and the turning consumer credit cycle, pointing to deteriorating unsecured lending and outstanding balances remaining above long-term sustainable trends.

- Although the central scenario of the 2007 *FRO* was one of relatively benign economic conditions and financial stability, it also noted the increasing risk that the operating environment over the next 18 months would be more challenging than in recent years.

- The 2008 *FRO* referred to the financial markets dislocation that took place in 2007 and noted: consensus forecasts of a less benign economic outlook for the UK and global economies; that downside risks were significant, making the financial sector more vulnerable to shocks; and that the existing business models of some institutions were under strain.

2.2.4 Ireland and Australia

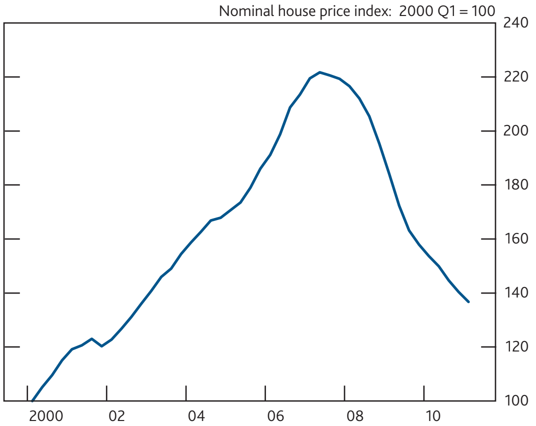
170. Ireland and Australia were key regions for HBOS's International Division.

171. Detailed analysis of the financial crisis in Ireland can be found in: *Misjudging risk: causes of the systemic banking crisis in Ireland (Report of the Commission of Investigation into the Banking Sector in Ireland), March 2011* and two preliminary reports: *The Irish Banking Crisis: Regulatory and Financial Stability Policy 2003 -2008*(26) and *A preliminary Report on The Sources of Ireland's Banking Crisis*.(27)

(26) *A report to the Minister for Finance by the Governor of the Central Bank, 31 May 2010.*
(27) *Klaus Regling and Max Watson, 2010.*

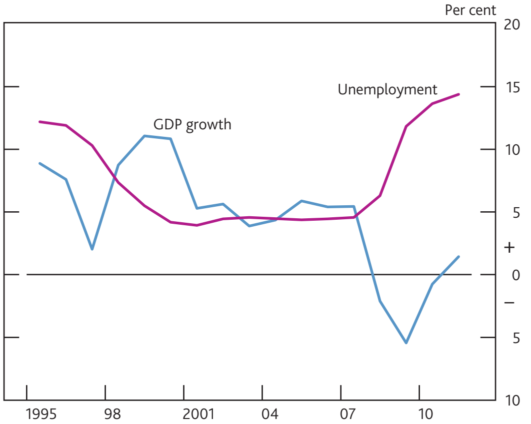
2

Chart 2.12: Irish residential property prices index[(a)]



(a) Source: OECD.

Chart 2.13: Ireland GDP growth and unemployment rate, 1995 – 2011[(a)]



(a) Source: International Monetary Fund, World Economic Outlook.

172. Analysis of the performance of the Australian economy and financial system can be found in the various *Financial Stability Reviews* of the Reserve Bank of Australia.

Ireland

173. Prior to the crisis, the Irish economy, which had seen a prolonged period of high economic growth and falling unemployment since the mid-1990s had been widely lauded as a model for small open economies.

174. Nevertheless, the Irish economy was highly dependent on the financial sector, construction spending and an extended property boom (Chart 2.12). It was supported by euro-area interest rates that were set too low for the Irish economy, cheap international funding and a procyclical fiscal policy. The report by the Governor of the Irish Central Bank described the final years of the boom as '*clearly bank led*' due to aggressive competition by the incumbent banks as well as new entrants, product innovation and a general decline in loan appraisal quality. Some commentators had raised concerns as early as 2000 about the housing boom[(28)] but did not always do so consistently or were modest in their criticism.

175. Ireland's economic performance therefore proved much less resilient than expected. Irish GDP fell by 2.1% over 2008 and by a further 5.5% in 2009 (Chart 2.13). Unemployment rose from 4.6% in 2007 to 12.6% in 2009. The effect on the property market was severe, with construction collapsing and both commercial and residential property prices falling dramatically. In late 2012, more than five years after the peak of the property boom, the Central Bank of Ireland noted that '…*normal Irish property market conditions still do not prevail*…'.

176. With concerns growing about the stability of the Irish banking sector, on 30 September 2008, the Irish government announced that it would guarantee all deposits held in domestically owned Irish banks. This created additional liquidity strain for non-Irish owned banks operating in the country as customers moved deposits to those banks with guarantees.

(28) An example warning on the Irish property market: http://www.imf.org/external/pubs/ft/scr/2000/cr0097.pdf.

Australia

177. Australia, the other key non-domestic market for HBOS, grew strongly during the pre-crisis period, benefiting from increased demand from rapidly growing emerging economies for its commodity production.

178. Initially, following the onset of the crisis, investor confidence in Australia was hit, with both the index of Australian banks' share prices and the broader ASX 200 market falling by around 50% by March 2009 from their late-2007 peak. Australia benefited, however, from the fact that a number of its key trade partners, such as China, continued to experience strong growth. Therefore demand for its export products, principally commodities, remained robust. The Australian economy maintained positive growth throughout the Review Period, with unemployment peaking at 5.6% in 2009, much lower than for many other developed economies.

179. House and commercial property prices in Australia did not experience the significant falls seen in the United Kingdom and Ireland. House prices suffered only a small dip in 2012. The commercial property market fared worse, with some sectors remaining weak more than five years after the onset of the financial crisis. However, the commercial property market was fragmented and there was considerable variation in performance between different geographic regions and segments. An index of prices for prime office space had declined 25% by 2010 from its peak, whereas construction in certain areas reliant on tourism in north and south east Queensland saw falls in value in excess of 50% from its peak.

180. The Australian financial system was affected by the crisis primarily from increased funding costs and falls in the availability of funding, but the overall impact was described as mild. In part this was due to the performance of the Australian economy, but it was also attributed to Australian banks' lower levels of sub-prime exposure and stronger balance sheets coming into the crisis. Further, credit standards had not been relaxed to the same extent as some other countries. Nevertheless, with about one third of their business lending being linked to commercial property, the Australian banks were not totally immune to losses.

2

2.3 The HBOS Group

2.3.1 The merger of Halifax and Bank of Scotland to form HBOS in 2001

181. Halifax Building Society was founded in 1853. It converted to plc status as part of a wave of demutualisation among building societies when it listed on the London Stock Exchange in June 1997. BoS was established in 1695 and grew over the following 300 years, following a strategy which mixed opportunities for acquisitions with organic growth.

182. In the period immediately preceding the merger, both firms grew steadily, but lacked scale in relation to competitors. In addition, BoS's rapid expansion in the absence of a large deposit base led to an increasing dependence on wholesale funding.

183. BoS made a number of unsuccessful attempts to expand over the period preceding the merger through acquisitions and mergers (for instance, bidding for NatWest). These attempts reduced the credibility of the firm and increased the likelihood that BoS would become the target of a takeover bid, prompting BoS to consider Halifax as an alternative merger partner.

184. Halifax and BoS announced their intention to merge on 4 May 2001. The combined stock market value of the two firms at the time was £28 billion. The two entities formally merged on 10 September 2001 to create HBOS. Mr James Crosby(29), Chief Executive Officer (CEO) of Halifax, became the CEO of HBOS, while Lord Dennis Stevenson of Coddenham, Halifax's Chairman, became HBOS's Chairman.

185. The merger was described by both parties as a merger of equals, structured as a nil premium merger based on a one-for-one share exchange ratio.(30)

186. The merger partners felt there was a compatibility of cultures between the two organisations. As Sir Peter Burt, BoS's CEO, stated: *'most important of all is that both shared a common philosophy. Each had an objective of aggressive growth by providing a first class service to our customers. Today we will provide the added value which will enable the combined business to grow strongly and profitably'*.

187. Mr Crosby echoed this view, claiming that: '*the creation of HBOS is all about growth; delivered through a pro-competition strategy which genuinely aspires to deliver outstanding outcomes for each of our three stakeholder groups: customers, colleagues and investors*'.

188. At the outset, HBOS aimed to become a fully-fledged member of the small group of major UK clearing banks. The key benefits of the merger were described in the announcement as:

- *'the amalgamation of the two groups' respective strengths in mortgages, savings, current accounts, personal loans and credit cards which will create product penetration opportunities across a wide range of retail financial services;*

(29) James Crosby became Sir James Crosby in June 2006 but relinquished this title in June 2013.
(30) For each share held in either party, shareholders of BoS and Halifax will receive one share in HBOS.

- *the combination of Bank of Scotland's expertise in business banking with Halifax's customer base and distribution capability which will create a platform for capturing a significant share of the profitable SME sector across the UK;*

- *the successful track record of Halifax in selling long term savings, life insurance and general insurance products. There is significant growth potential from extending this capability across the HBOS customer base; and*

- *the increased financial strength and deposit base of HBOS which will enable Bank of Scotland's corporate banking operations to generate and retain higher value corporate banking transactions'*.

189. At this stage, International was notable in its absence. This re-focus came later, in 2004, on the back of a perceived softening in the UK mortgage market. There was also a view that: '*…having acquired the BankWest shareholding via Bank of Scotland,* [HBOS] *had to make the best of the situation …and make the assets perform*'.(31)

Box 2.2: External views of the merger

While the respective BoS and Halifax shareholders approved the merger, the views of analysts varied. Some saw it as a positive move for both BoS and Halifax, giving a stronger business profile, good strategic fit, greater diversification and expected cost and revenue synergies. One broker noted that the two firms had *'very little overlap and have genuine potential for cross-sell'*.

The circumstances in which the merger was agreed had not gone unnoticed, however. One analyst commented: '[Bank of Scotland] *management look to be under some pressure to do a deal, and we suspect every effort will be made to get this one through'*. Another pointed to the severe margin pressure faced by both Halifax and BoS ('*possibly the worst in UK banking*') before proceeding to note that: '*it's noticeable that it wasn't the first choice for either party…Both … are seeking to reduce their dependence on their historical core activity. Yet it doesn't, we think, follow that there's a necessary portfolio win through diversification. Cannot two strategically challenged businesses become one rather bigger strategically challenged business?*'

One analyst questioned HBOS's ambitions to acquire 11% of the small and medium sized enterprise (SME) market, which was considered '*very ambitious for an area that is largely inert*', though another was more optimistic: *'It is in the SME banking sphere that the core rationale of this deal lies…we see little potential downside. Coming from a virtually zero* [cost] *base, there is nothing to be lost*'.

Analysts also questioned the economic outlook in two of HBOS's key sectors – household and corporate lending: *'HBOS' value has risen by over £3 billion since the announcement … we can find £4 billion of value. In essence, however, the fortunes of HBOS will depend on the outlook for mortgage savings (Halifax's core); and the outlook for corporate lending (BOS's core). Base case pro-forma growth is likely to be below the sector's*'.

2.3.2 HBOS Group structure

190. HBOS did not become, nor did it seek to become, a global universal bank to the extent that some of its UK peers did, whether through overseas acquisitions or expanding into investment banking. The Group remained largely a retail and commercial bank with a presence in the English-speaking world.

(31) See section 2.5.2, '*Divisional strategy*' of the International Division.

191. HBOS Group was predominantly a banking organisation, although it had a substantial insurance business, which represented around 15% of total assets. During the Review Period the Group underwent a number of restructurings, but broadly consisted of five divisions in a strongly federated structure.

192. The largest HBOS division by assets throughout the Review Period was Retail Division, which also contributed the largest share of profit until 2007, when it was surpassed by Corporate. The division was mainly a continuation of Halifax's substantial UK retail business. It provided the full range of retail and small business(32) products to over 23 million customers, and held approximately a 20% share of the UK mortgage market.

193. Corporate Division was the second largest division of the Group and was the extension of the corporate business of the BoS. It provided a range of commercial banking and specialist services, with a particular focus on commercial property lending, infrastructure finance, leveraged finance and, increasingly during the Review Period, private equity. It prided itself on the ability to provide innovative and integrated funding packages. The division did not offer the core investment banking activities, and was not typically a lender to FTSE 100 companies.

194. The third banking division was International Division, which was formed in 2004 to allow greater focus to be given to the international businesses of the Group. It consisted of banking operations in Australia, Ireland, Europe and North America, of which Australia and Ireland were the most significant markets. In Australia and Ireland, it provided a range of banking services to commercial and retail customers. In both countries there had been rapid expansion in retail operations; while commercial lending had a focus on commercial property.

195. The Treasury and Asset Management Division's most important function was to manage the funding and liquidity of the HBOS Group. Two further core functions were to provide financial services to the group and its customers and to deliver profits. The division also included the asset management business of the Group.

196. Insurance and Investment Division was responsible for the underwriting and administration of the insurance business, both life and general (including brands such as Clerical Medical).

197. The Group also had a number of small joint ventures, notably Sainsbury's Bank (a retail bank), esure (an insurer), and St. James's Place (a financial advisory firm).

2.3.3 HBOS's strategy and business plans: 2004 to 2008

198. From the merger onwards, HBOS set out its strategy in its annual business plans. The business plans were prepared on a 'bottom-up' basis by individual divisions, both reflecting and reinforcing HBOS's federal structure. The Group business plan largely represented an aggregation of the financial plans of each division, though there was a broad framework and some support provided at Group level, such as the provision of macroeconomic scenarios.

199. HBOS publicly described the following elements to its strategy in its accounts:

- growing the UK franchise, with a goal of attaining 15-20% market share for the Group's main products;
- targeted international expansion by exporting the UK model;

(32) Small businesses were those with less than £1 million turnover.

- cost leadership: to provide flexibility to deliver further growth ahead of the competition;
- colleague development: to have the best leadership teams and to provide colleagues with the necessary training and development; and
- capital discipline: to allocate capital to those parts of the business that will provide sustainable returns to shareholders.

200. The Group business plans additionally set out:

- a target return on equity of around 20%;
- that the focus was on organic growth rather than through acquisitions, building on the existing strengths of the retail and corporate businesses; and
- that the Group would be a challenger and consumer champion, offering competitive products and showing the flexibility that more established players could not.

201. In the years following the merger the divisions had been encouraged to '*go for growth*' and the firm rapidly grew its assets, which it noted had made it an outlier.

202. Around the start of the Review Period the emphasis on asset growth became more cautionary, with restrained and paced growth the bywords for the UK business, although there was still an aim for '*continued strong asset growth in our International businesses where we are positioned as a new competitor and returns remain attractive*'.

203. In seeking growth, HBOS built on what it believed to be its strong position in the property sector – a natural choice given the two predecessor firms' strengths in residential property (Halifax) and commercial property (BoS).

204. HBOS largely targeted organic growth rather than acquisitions, reflecting the belief that acquisitions were more risky given the inherent execution risk. While the HBOS Board did initially consider a number of potential large-scale acquisitions, it ultimately rejected these. For example, Mr Crosby noted that the Board considered, but decided not to proceed with, the acquisition of Abbey National in 2004. Nevertheless, by 2007, inorganic growth was perceived as an option to expand International.

205. Expanding HBOS's international operations was seen as diversification at the time. Moving into Australia, with its pool of natural resources, might have had the potential to provide HBOS with some diversification benefits, however this was not the case with Ireland. As was known at the time, Ireland retained close links to the performance of the UK economy and financial system, with Irish banks significant investors in UK commercial property markets, and UK banks big investors in Ireland. Consequently, expanding in Ireland did not reduce the significant exposure to a downturn in the UK market.

206. In international markets, HBOS sought to deploy the same capabilities and skills as it did domestically; this meant that in these areas, too, HBOS had a large property concentration. It was a conscious decision to grow property exposures in Australia and Ireland. HBOS also had retail mortgage exposures in mainland Europe (the Netherlands and Spain).

207. To deliver its goals the Group felt it had a number of significant competitive strengths relative to competitors:

- the 'safest' balance sheet in UK banking, with strong property backing to both retail and corporate balance sheets;
- multi-brand distribution strength in Retail and Insurance & Investment;
- the United Kingdom's most successful bancassurance franchise;
- a leading edge integrated finance proposition (i.e. the willingness to provide both equity and debt in a deal);
- low cost-to-income ratios in all core businesses;
- 'strong' capital ratios; and
- a 'strong' top team.

208. At the same time, the Group acknowledged some serious strategic weaknesses that it needed to address, these included:

- a lack of scale in SME banking;
- a lack of sufficient credit risk capability;
- an over-reliance on wholesale funding;
- unsatisfactory customer service levels;
- a lack of international diversification; and
- a lack of depth in the senior talent pool.

209. HBOS held itself to these goals up until 2008, with only a few exceptions (for example, a move away from market share targets in Retail for a short period at the start of the Review Period). The goals provided a clear direction for the firm towards which all activity could be focused and appeared at the time to be compelling to the market.

210. The Group's annual business plans are described in more detail in Box 2.3.

Box 2.3: HBOS: annual business plans

In the years immediately prior to the Review Period, HBOS's annual business plans focused strongly on the merger and exploiting its synergies (for example, 2001's strapline was *'creating the new force in banking'*) as well as aiming for high growth and increased market share.

From 2004, the tone became more conservative in recognition of the late stage in the economic cycle and that the integration synergies were largely exhausted. The strapline for the Group Business Plan 2005 – 2009, produced in 2004, was *'less is more'* and encouraged a focus on quality over quantity – for instance, focusing on: less asset growth, less focus on headline profit growth and more on earnings per share growth; and less dilution through issuance and more shareholder value with buybacks. This also signalled an increased focus on non-interest income. Nevertheless, the plan targeted 10% growth in profits for 2005 for the Group, which, as the FSA supervision team recorded at the time was *'far from slow'*.

The Group Business Plan 2006 – 2010, produced in 2005, was set out in a similar tone to the previous one under the banner of '*targeted growth*', which the plan defined as ambitious but realistic average asset growth of 9% per annum.(33) HBOS had predicted a domestic slowdown, particularly in the housing markets, and therefore the plan set out a more restrained approach in the core UK retail and corporate markets (targeting 8% and 6 – 9% asset growth per annum (p.a.) respectively). Despite the more cautious tone, HBOS still aimed to be 'top 3' in all UK markets and targeted a 15 – 20% market share in almost all markets. It also aimed for strong growth in International (ca. 20% p.a.), where returns were considered more attractive, in the hope that this would diversify HBOS's overall portfolio.

The market share objective remained in the Group Business Plan 2007 – 2011, produced in 2006. The plan outlined *'six strategies for success'*, which were: growing the UK franchise, targeted international expansion, managing risk, getting customer service right, cost leadership and building the best team in banking. HBOS forecasted continuing GDP growth in major economies and a benign business environment, though it still predicted overall asset growth of 8% p.a. in the United Kingdom and 10% p.a. for the Group. It was more bearish about the UK retail market, noting high levels of consumer indebtedness and the attendant pressure on affordability, but was more ambitious on the International front, targeting growth of 23% p.a., while Corporate's growth rates were increased relative to the previous plan.

The turn of the economic cycle was explicitly acknowledged by the Group Business Plan 2008 – 2012, produced in 2007, with the strapline '*when the going gets tough*'. The opening two paragraphs of the plan recorded that: '*The Group Business Plan has been prepared against the backdrop of unprecedented financial turmoil in global markets which has required significant adjustments to the plans as originally submitted by Divisions. We expect a "New Order" to emerge under which the supply of funding will be constrained and this in turn means that we cannot simply rely on asset growth to deliver shareholder value*'. And: '*The Plan assumes that the financial markets gradually re-open in 2008 and were this not to happen, a re-plan would be necessary, not only for us – but the UK banking sector.*'

The plan also noted that '*confidence in the UK and, in particular UK banking, has taken a battering during the recent market turmoil and will take quite some time to recover*'. It went on to say, however: *'On a brighter note, confidence in HBOS does not seem to have declined relative to the UK banking sector – in fact – the reverse may be closer to the truth',* suggesting that the firm set itself above its peers in its resilience against the financial markets dislocation. The substance of the plan was then predicated on a '*…relatively benign outlook for the UK* [that] *could prove to be optimistic, particularly given the rising cost of funds*' and the strategic objectives continued to focus on attaining 15 – 20% market share in HBOS's key markets, while overall growth for the Group was targeted at 6% for 2008 and 9% annually thereafter. Retail was the primary driver (4% in 2008) of the reduced target growth rate given its overall size, with International also targeted for a significant reduction in asset growth (dropping to around 15% for 2008).

The Group's growth targets were pared back as conditions failed to recover, notably in March 2008 when its ExCo decided that '*asset growth should come in £6bn under Plan in 2008, spread equally across Retail, Corporate and International*'.

There is some evidence that the firm did belatedly realise that its long-term growth targets had been extremely ambitious. Shortly before the failure of HBOS, Mr Andy Hornby, HBOS Group CEO, stated as part of a strategy away day that: '*we must … be hard on ourselves in admitting some of the self-inflicted actions that have made our strategic position even tougher. In particular … we did grow the business extremely strongly from 2002 through to 2007*'.

(33) 9% in 2006, 2008 and 2009; 10% in 2007 and 8% in 2010.

2

2.3.4 HBOS Group's reported performance: 2004 to 2008

211. As shown in Table 2.1, HBOS was highly profitable in the period from 2004 to 2007, reporting profits annually of between £4.6 billion and £5.7 billion.

Table 2.1: HBOS Group summary income statement 2004 – 2008[a]

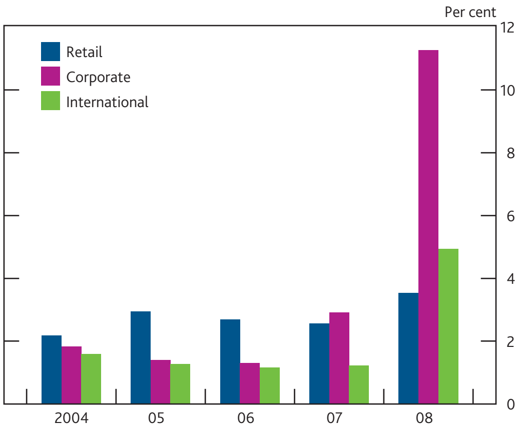
£ billion	2004	2005	2006	2007	2008
Net interest income	5.9	6.8	7.4	7.3	8.2
Net fees and commission income	1.5	1.0	1.2	1.3	1.1
Net trading income	0.2	0.2	0.3	0.2	(2.9)
Insurance (net)	2.0	2.7	2.7	2.6	1.7
Other income[b]	1.2	1.3	1.7	2.6	0.1
	10.8	**12.0**	**13.3**	**14.0**	**8.2**
Administrative expenses	(4.2)	(4.6)	(4.6)	(5.0)	(5.1)
Depreciation, amortisation and goodwill	(0.8)	(0.9)	(1.2)	(1.4)	(1.8)
Impairments	(1.2)	(1.7)	(1.8)	(2.1)	(12.1)
Group pre-tax profit	**4.6**	**4.8**	**5.7**	**5.5**	**(10.8)**
Analysis of Group pre-tax profit by division					
Retail	2.0	1.9	2.3	1.9	1.3
Corporate	1.3	1.4	1.6	2.3	(6.8)
International	0.4	0.6	1.0	0.7	(0.8)
Treasury and Asset Management	0.3	0.3	0.4	0.3	(3.6)
Insurance and Investment	0.8	0.8	0.7	0.6	(0.3)
Group items	(0.2)	(0.2)	(0.3)	(0.3)	(0.6)
Group pre-tax profit	**4.6**	**4.8**	**5.7**	**5.5**	**(10.8)**

(a) Source HBOS *Annual Reports and Accounts* and Review calculations.
(b) Including from associates and joint ventures.

212. For much of the Review Period, HBOS's impairment position also looked benign. Between 2004 and 2007, HBOS's impaired loans as a percentage of total loans – a key metric by which asset quality was reported to the Board – remained largely unchanged between 2% and 2.4% (Chart 2.14). Only in 2008 did impairments begin to rise sharply. At a divisional level, the record of impairments suggested that Retail Division carried the higher risk for the firm until 2007. This may have diverted the firm, and regulatory focus, away from the other divisions, where in fact greater risks were developing.

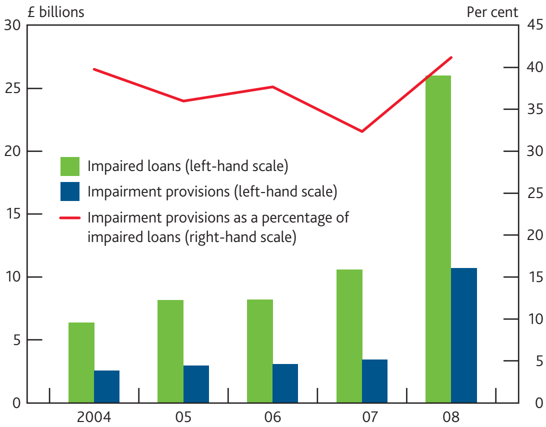
213. The level of impairment provisions as a percentage of impaired loans steadily declined between 2004 and 2007 (Chart 2.15), driven by the International and Corporate Divisions (Chart 2.16). This seems to suggest that the quality of the Group's assets was slowly improving during this period. However, analysis of the assets in Corporate and International (Sections 2.4 and 2.5) suggests that the opposite was the case. Rather, the prolonged benign economic period had given rise to a belief that relative asset quality had improved. Developments in 2008 provided a sharp reminder that this was not the case.

Chart 2.14: HBOS Group impaired loans as a percentage of total loans by division[(a)]



(a) Source: HBOS *Annual Reports and Accounts*.

Chart 2.15: HBOS Group impaired loans and impairment provisions[(a)]



(a) Source: HBOS *Annual Reports and Accounts*.

HBOS Balance sheet: 2004 – 2008

Table 2.2: HBOS total assets and annual growth by division 2004-2008[(a),(b)]

£ billion	2004	2005	2006	2007	2008	Compound annual growth
Retail	209	225	243	260	266	6%
Corporate	82	87	97	122	128	12%
International	37	50	61	76	68	16%
Banking divisions	**328**	**362**	**401**	**458**	**462**	**9%**
Treasury and Asset Management	85	107	107	120	147	15%
Total banking activities	**413**	**469**	**508**	**578**	**609**	**10%**
Insurance and other group items	64	72	83	89	81	6%
Total group assets	**477**	**541**	**591**	**667**	**690**	**10%**

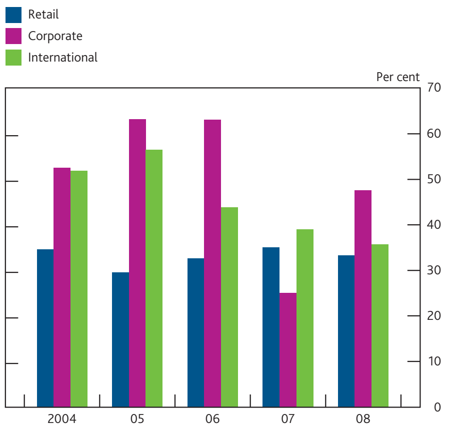
(a) Source: HBOS *Annual Reports and Accounts* and Review calculations.
(b) 2004 has been adjusted to reflect the implementation of International Financial Reporting Standards (IFRS) in 2005.

214. Asset composition by sector was largely unchanged during the Group's life. Over 75% of its banking assets were represented by loans and advances to customers (Chart 2.17), with a heavy property concentration and increasing exposure to commercial real estate (CRE).

215. The Group also had significant holdings of investments. These were predominantly held by the Treasury Division, including a pool of assets to manage the Group's liquidity needs (Section 2.7), but also arose from private equity and similar activities by Corporate Division (Section 2.4).

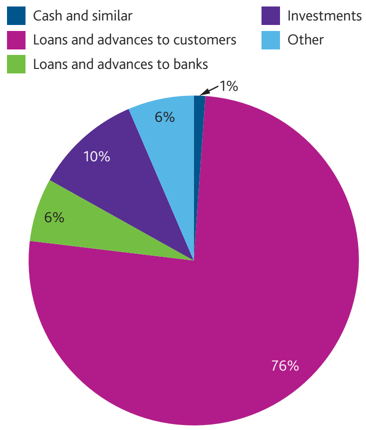
2

Chart 2.16: HBOS Group impairment provisions as a percentage of impaired assets by division(a)



(a) Source: HBOS *Annual Reports and Accounts*.

Chart 2.17: Composition of the HBOS Group banking book balance sheet as at December 2007(a)



(a) Source: HBOS regulatory reporting.

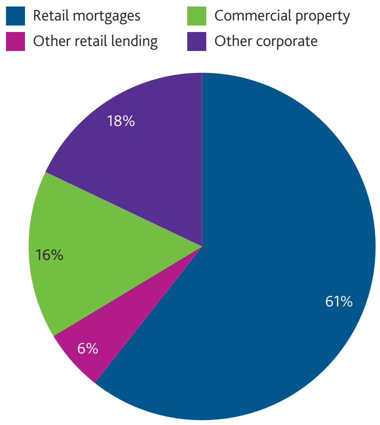
216. In aggregate, the Annual Report and Accounts show property (retail and commercial) dominated the Group's lending, representing over 75% of loans and advances at the end of 2007 (Chart 2.18). This was little changed from 2001, though there had been an increase in the proportion of the balance sheet lent on commercial property, with a similar decline in residential mortgages:

- Despite faster growth in corporate lending, retail lending remained the largest part of the Group, representing around 67% (£288 billion) of total loans at end-2007 (Chart 2.18). Mortgages accounted for by far the largest share of retail lending (£263 billion), a legacy of the Group's building society past, and where it offered the full range of products, including buy-to-let (BTL), interest only and self-certification loans (though limited sub-prime). Other personal lending, including credit cards and unsecured personal loans, totalled £25 billion.

- By the end of 2007, HBOS's corporate loans were £146 billion. Almost half of this lending (£68 billion), was to commercial property or heavily dependent upon the performance of property (e.g. hotels and restaurants), up from just over a third in 2001. The remainder of the corporate lending was spread across a range of sectors, though some of this was also property related. The Annual Report and Accounts however did not analyse around £20 billion of non-UK corporate lending. Information in the Corporate and International sections indicates a significant component of this lending was also property based. The Group's commercial property exposures were therefore more likely between £80 and £90 billion.

217. In terms of geographical exposures, in 2001, less than 10% of the Group's assets had been outside the United Kingdom. From around 2004, when the Group started expanding its Irish and Australian businesses, the international businesses grew rapidly, and by 2007 accounted for around 20% of Group assets. As with the UK business, property formed a significant component of the balance sheet in both Australia and Ireland.

Chart 2.18: Segmental analysis of HBOS Group loans and advances as at December 2007[a]



(a) Source: HBOS *Annual Report and Accounts 2007*.

218. Given this lending profile, the Group was always going to be heavily exposed to any downturn that affected the property market, and it became increasingly vulnerable due to the growth in its exposure to higher risk commercial property lending.

219. Sections 2.4 (Corporate Division), 2.5 (International Division), 2.6 (Retail Division), and 2.7 (Treasury Division) consider in more detail the nature and quality of the assets of the various divisions.

2.3.5 Did HBOS deliver on its strategy?

220. This section looks at HBOS's main strategic aims (as set out in Section 2.3.3) and considers whether the firm achieved them, as well as the risks it took while pursuing these aims.

A 20% return on equity – but at what cost?

221. HBOS envisaged a 'virtuous circle' of volume growth, stable margins, strong credit quality and cost control which would, in theory, lead to increased profitability. For the majority of the Review Period this appeared to be the case. The Group was highly profitable and reported annually in its financial statements a 20%[34] return on equity, in line with peers.

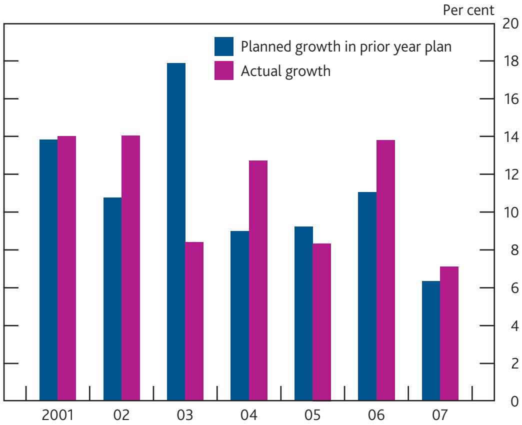
222. HBOS's approach of pursuing rapid balance sheet growth during this period was also not out of line with peers. HBOS's annualised total asset growth rate between 2001 and 2007 was 13%, compared to the Royal Bank of Scotland (RBS) at 20%, Lloyds TSB at 7%, HSBC at 23% and Barclays at 23%.

223. The majority of UK banks were seeking to grow strongly pre-crisis, though the composition and drivers of this growth rate differed across the peer group. HBOS's growth focus was organic rather than acquisition led (the approach taken by RBS). HBOS was less diversified by geography (focussing its expansion on English-speaking areas) than HSBC, for example. While Barclays' primary area for growth was its investment banking operations, HBOS did not pursue this business line.

(34) 2006 was the only year for which the firm reported a return on equity in excess of 20%. In the other years the firm reported a return on equity of 19.6% or 19.7%.

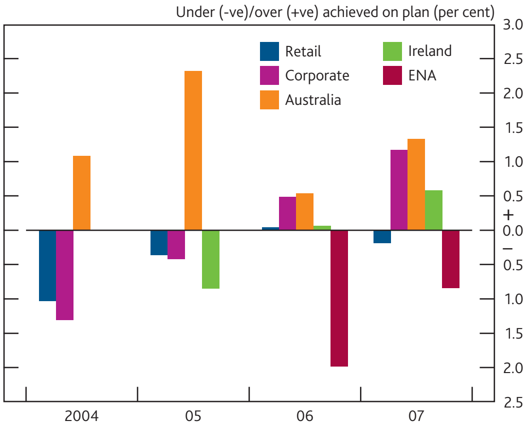
2

Chart 2.19: Planned Group asset growth and actual variance to plan[(a)]



(a) Source: HBOS Group Business Plans, *Annual Reports and Accounts* and Review calculations.

Chart 2.20: Variance of actual asset growth to plan by division[(a),(b)]



(a) Source: HBOS Group Business Plans, *Annual Reports and Accounts* and Review calculations.
(b) The growth rates for Ireland and ENA in 2008 were inflated by the significant appreciation of the euro against sterling.

224. HBOS growth targets changed over time. Early on in its lifetime (between 2001 and 2004), HBOS had a clear aim for strong growth, expanding its balance sheet rapidly (indeed faster than peers) while exploiting merger synergies to keep the growth in its cost base low. The firm's total assets grew at a rate of 12% annually over this period. From 2005 onwards, however, HBOS looked to reduce asset growth, aiming for about 8-10% annually in its core markets; resulting in a lower growth rate during this period (Chart 2.19).

225. With the exception of 2004, the Group largely met its overall asset growth targets and, more often than not, it exceeded them.[(35)] However, results varied significantly across the different divisions (Chart 2.20). HBOS Australia (HBOSA), for example, consistently exceeded plan in the years to 2007, while Europe and North America (ENA) significantly underperformed plan in both 2006 and 2007.

226. In 2008, as the crisis took hold, the Group sought to reduce its asset growth further. However, the Group still met its original plan, highlighting the momentum that existed in the lending model.

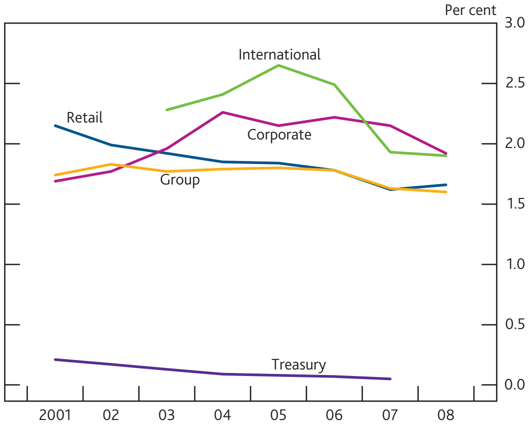
A stable Group net interest margin but not without a step up in the risk profile of the firm

227. By 2004, the synergy benefits from the merger were largely exhausted and no longer boosted HBOS's bottom line. At the same time, real interest rates had been generally falling (see Section 2.2.2) reducing returns and profitability. Low rates contributed to rapid growth in credit extension as lenders were able to access cheap wholesale funding. This increased competition in the already competitive UK retail mortgage market depressing margins on mortgage business.

228. In response, in its Group Business Plan 2005 – 2009, HBOS placed an increased emphasis on preserving its interest margins to sustain profitability and targeted a stable group margin. It recognised however that the experience of the different divisions might be different: in particular, it expected a modest decline in the Retail margin. The Plan also expressed a desire to grow non-interest income to reduce the Group's reliance on net interest income. These aims were broadly repeated in the subsequent business plans, as the competitive market environment continued to put downward pressure on margins.

(35) Retail was the principal cause of the Group underperforming in 2004, as lending was cut back in the face of a softening in the mortgage market.

Chart 2.21: Net interest margins by division[(a),(b)]



(a) Source: HBOS *Annual Reports and Accounts*.
(b) Net interest margin at divisional level is approximate, and depends upon the funds transfer pricing regime in force at any one time.

229. In looking to preserve margins, each of the lending divisions moved up the risk curve during the Review Period. For example, Retail increased its exposure to specialist mortgages[(36)], and both Corporate and International increased the size and complexity of their deals.

230. More broadly, there was a shift away from growing Retail, which was suffering increased impairment losses (notably in its unsecured book) as the UK economy softened, towards Corporate and International, where margins were higher but the risks were also greater.

231. The net effect of the competitive environment, the divisional actions and other factors (e.g. extending the maturity of funding increased costs within Treasury and contributed to a fall in its interest margin) was a small decline in the Group's interest margin between 2005 and 2007. During the same period the Group was also not successful in expanding significantly the level of non-interest income, except in Corporate. Ultimately, to maintain and grow income and profits HBOS had to increase its lending and grow its balance sheet.

Market share targets results mixed

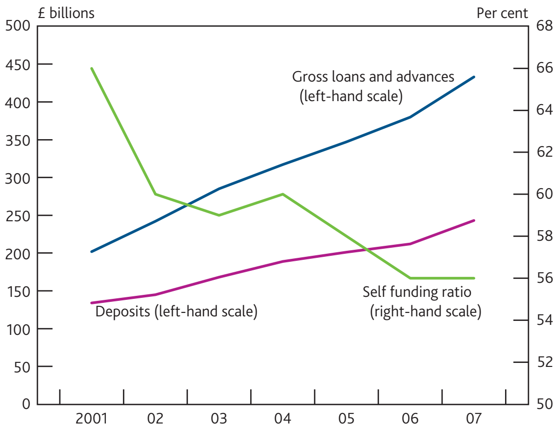
232. A very competitive market also made it challenging for HBOS to meet its market share targets. In practice, HBOS did not succeed in gaining the market share it hoped for except in those markets where it was already strong at the time of the merger (e.g. retail mortgages, UK commercial property).

233. The Corporate Division was not able to offer the full service capabilities of the more established UK business banks. For example, it did not have the infrastructure to issue bonds, nor did it have the branch network capabilities that would have allowed it to service UK SME customers effectively. As a result, HBOS was unable to make significant headway in SME banking – a key objective at the time of the merger – in order to build the level of deposits and therefore decrease its funding gap. It was, however, able to leverage off the Group's bigger balance sheet to undertake increasingly large corporate transactions.

(36) Self-certification and buy-to-let mortgages.

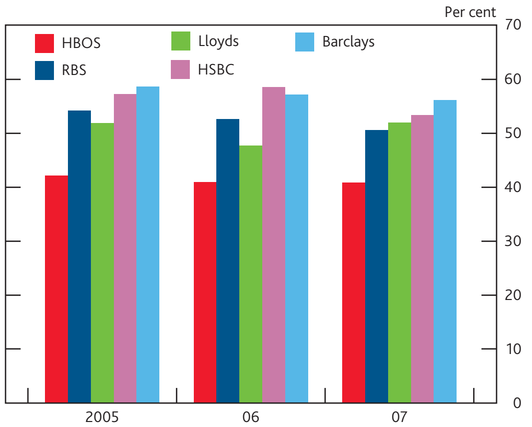
2

Chart 2.22: Loan and deposit growth and self-funding ratio of the Group[(a)]



(a) Source: HBOS ExCo paper, June 2008.

Chart 2.23: Major UK banks' cost-income ratios[(a)]



(a) Source: *Annual Reports and Accounts.*

Growth aggravated known weaknesses in the business model

234. While the Group found it reasonably easy to grow its assets, it found it much more difficult to increase deposits. As a result, with the exception of a small pick-up in 2004, the Group's self-funding ratio declined steadily from around 66% in 2001 to 56% in 2007 (Chart 2.22), while the customer funding gap almost trebled from £68 billion to £190 billion.

235. In July 2008, the Group noted:

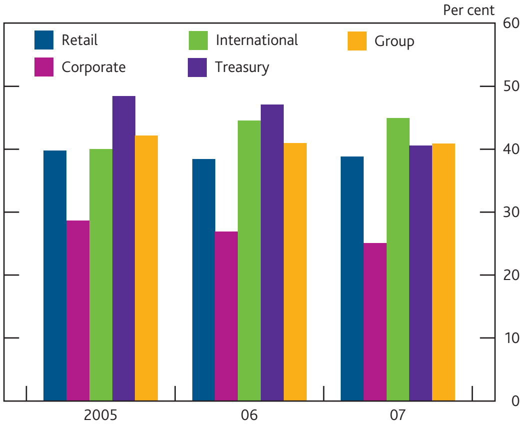
> '*A review of prior year plans and actuals indicates that a significant juncture was reached in 2006. The 2006 – 2010 Plan adjusted the Retail deposit targets downwards based on the disappointing savings performance recorded in 2005. The Corporate deposit Plan for the same period was adjusted upwards; however this Plan was not delivered during 2006 as we took the strategic decision to price away hot money deposits. A strongly focused asset led growth strategy continued in Corporate during 2007 and deposit targets were rebased at a lower level following the 2006 experience.*
>
> *The funding plan that accompanied the 2007 – 2011 Business Plan signalled that the Group had sufficient funding capacity to cover the funding gap implicit in the divisional operating plans with sufficient short term excess capacity to cover any temporary illiquidity in term markets. However, there was an imprudent level of long-term excess capacity in case of market disruption.*'

236. It concluded: '*Since merger, HBOS has always had a material reliance on the wholesale markets … we did continue with a business model which extended a known weakness*'.

Cost leadership acted as a disincentive to invest in controls and risk management

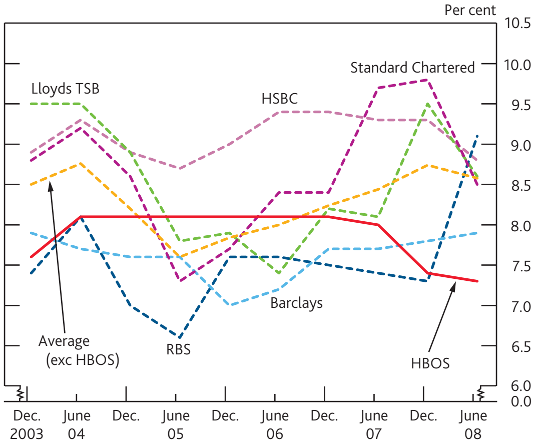
237. HBOS viewed its low cost base as a key competitive advantage compared to its peers, and focused heavily on progressively reducing its cost-income ratio. In practice, it was only marginally successful in doing so between 2005 and 2007, though its cost-income ratio remained significantly below peers during this period (Chart 2.23).

Chart 2.24: HBOS Group and divisional cost-income ratios[(a)]



(a) Source: HBOS *Annual Reports and Accounts*.

Chart 2.25: UK banks published Tier 1 ratios[(a)]



(a) Source: *Annual Reports and Accounts and Interim Results*.

238. However, the pressure to keep costs down may have led HBOS to make decisions that led to deficiencies in the infrastructure required to run a successful, low risk lending business and contributed to the increase in its risk profile. The minutes of the ExCo away day in June 2006, for example, noted the importance of continuing costs discipline, stating that: *'investment would be targeted primarily at areas of revenue production'*.

239. An October 2007 Board paper on the Retail strategy for 2008 – 2012 acknowledged that: *'we have always kept a tight rein on costs … Living within our tight cost constraints has led to under-investment in building future capability for growth – whether in our basic systems infrastructure, the skills of our customer-facing colleagues or our cross-product and cross-channel coordination'*.

240. Further, the desire to keep costs low appeared to have led to a bias towards growing the areas where the infrastructure was already in place and therefore cost-income ratio was relatively low, such as in Corporate Division (Chart 2.24). The decisions and actions taken, therefore, served to disadvantage non-revenue generating areas, such as the control functions, in terms of investment. It also exacerbated concentration risk in certain business areas, ultimately leading to growth outstripping the ability of the risk and control infrastructure to cope.

241. In Corporate too, investment in the control framework lagged business growth. The Group Business Plan 2005 – 2009, prepared in 2004, highlighted the challenges in trying to increase non-interest income while keeping tight control of expenses and that '…*business areas are crying out for investment'*. Yet in 2007 it was noted by ExCo there had been 'historic under investment', while the Corporate Divisional Business Plan noted: *'Our back office processes have not kept pace with the rapid growth in our business.'*

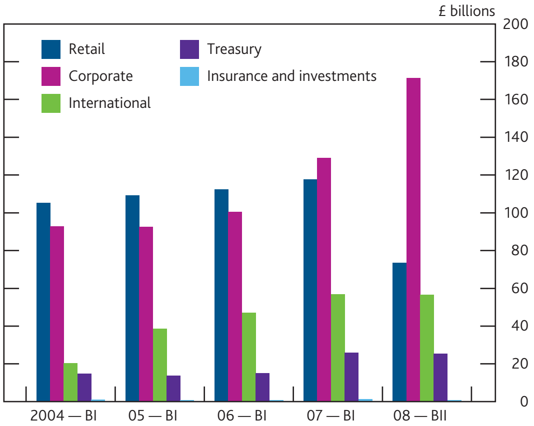
Capital management was 'efficient' and not out of line with the standards of the day, but ultimately was not sustainable

242. Given HBOS's aspirations to achieve a high return on equity, minimising capital was seen as efficient management rather than something which could increase the risk profile of the firm.

243. HBOS set itself an 8% Tier 1 target capital ratio, a level that was above the minimum 4% prescribed by Basel I, and one the firm considered prudent. At the time, this approach appeared consistent with peers (Chart 2.25).

2

Chart 2.26: Reported risk weighted assets by division[(a),(b)]



(a) Source: HBOS *Annual Reports and Accounts*.
(b) The Insurance and Investment Division's RWAs are excluded as negligible.

244. In order to maximise returns to shareholders, HBOS sought to pay out what it considered to be excess capital through dividends or share buybacks.(37) HBOS set a maximum dividend cover ratio of 2.5 (meaning that it committed to paying out at least 40% of its earnings) and in 2007 announced that it would increase its dividend pay-out ratio to 46% (albeit in a trade-off with a reduced share buy-back). This was not out of line with other UK banks.

245. As a result, HBOS paid out around £11 billion in dividends and share buybacks from its formation in 2001 to its takeover by Lloyds TSB in 2008(38), with the last payment made on 12 May 2008 (£1.2 billion).(39) While this was inadequate to absorb the full losses that HBOS ultimately sustained, and it is unrealistic to have expected the firm not to have paid any dividends, greater capital retention during this period would have reduced the scale of the shortfall that was eventually faced when losses crystallised from 2008 onwards.

246. The risk-weighted assets (RWAs) of the different HBOS divisions were determined using Basel I methodologies until 2007. As these methods were relatively insensitive to risk, the growth in HBOS's RWAs during this period broadly followed that of its assets. This measure also suggests that the greatest risk resided in Retail Division until 2007, when Corporate Division had the largest RWAs, driven by the significant asset growth in that year (Chart 2.26).

247. There was a substantive change to HBOS's RWAs in 2008, following the introduction of Basel II and the use of more risk-sensitive approaches. These changes emphasised that Corporate Division carried the majority of the Group's risks, accounting for over 50% of the Group's RWAs by end 2008, while Retail Division's share of RWAs fell to around 20%.

248. Basel I may have disguised to management the relative risks of the different HBOS divisions and led to a disproportionate focus being placed on risks in Retail relative to Corporate. Moreover, as set out in more detail in Section 2.9, the firm's approach, while ensuring it met the regulatory standards of the time, failed to ensure that it held capital of sufficient quality and quantity for the risks that were accumulating.

(37) Buybacks have the additional effect of increasing earnings per share – considered by HBOS (and its peers) as a key performance metric.
(38) £8.5 billion in dividend pay-outs and £2.5 billion in share buybacks.
(39) The final 2007 dividend on ordinary shares, announced in the February 2008 preliminary results announcement.

2.3.6 HBOS's performance from 2008

249. From 2008, HBOS's performance deteriorated dramatically. Between 2008 and 2011, the Group reported a cumulative loss of £24.1 billion (Table 2.3). After the payment of dividends (£1.3 billion in 2008 and £0.5 billion in 2009) the Group's equity was reduced by £26 billion by the end of 2011.[40] Approximately £21.3 billion of this fall came after the receipt of ELA in October 2008 (Table 2.24). The loss was more than total shareholder equity of £22.2 billion at the end of 2007 and it was larger than £13.5 billion (a Basel III estimate of going concern loss absorbing capital[41]) (see also Sections 2.9.6 and 2.9.7).

250. The losses were substantially driven by impairments of £52.6 billion during this period. Other notable contributions to HBOS's losses included:

- losses on joint ventures and associates totalling £1.8 billion predominantly in 2008 and 2009;
- a provision for Payment Protection Insurance (PPI) compensation of £1.2 billion in 2011 (increased to £3.4 billion by the end of 2014);
- a loss on the disposal of the BankWest business, which was a significant part of the Australian operation, of £0.8 billion in 2008; and
- a loss on disposal of the insurance business of £1.7 billion following an internal group restructure in 2011.

Table 2.3: HBOS Group reported results 2008-2011[(a),(b),(c),(d)]

£ billion	2008	2009	2010	2011	Cumulative 2008 to 11
Net interest income	10.1	5.7	8.4	8.4	32.6
Net fees and commission	0.9	0.5	0.5	1.1	3.0
Net trading income	(12.9)	8.9	9.1	(0.9)	4.2
Net insurance income	10.0	(6.4)	(5.5)	0.7	(1.2)
Other income	1.8	7.0	2.1	1.1	12.0
Total income	**9.9**	**15.7**	**14.6**	**10.4**	**50.6**
Operating expenses	(6.9)	(6.9)	(5.7)	(5.5)	(25.0)
Impairments	(13.5)	(21.1)	(10.9)	(7.1)	(52.6)
Disposals and joint ventures	(1.8)	(0.7)	(0.1)	(1.7)	(4.3)
Loss before tax	**(12.3)**	**(13.0)**	**(2.1)**	**(3.9)**	**(31.3)**
Tax	3.8	2.7	(0.3)	0.2	6.4
Loss after tax recognised in the income statement	**(8.5)**	**(10.3)**	**(2.4)**	**(3.7)**	**(24.9)**
Other gains and losses	(4.7)	3.1	0.7	1.7	0.8
Total recognised income and expense	**(13.2)**	**(7.2)**	**(1.7)**	**(2.0)**	**(24.1)**

(a) Source: HBOS *Annual Reports and Accounts* and Review calculations.
(b) The 2008 results in this table differ to the 2008 results shown in Table 2.1 for two reasons: alignment of HBOS's accounting policies and presentation with Lloyds Banking Group following acquisition; and an accounting clarification by IFRIC in 2010 that resulted in a prior year adjustment affecting impairments on AFS assets.
(c) Net trading income includes fair value movements on the assets backing the Group's insurance liabilities as well as trading gains and losses on the Group's banking activities.
(d) Net insurance income is insurance premium income less claims.

(40) As set out in section 2.9.6 the Group undertook various capital raising and other actions to restore its equity position to cover these losses.
(41) Shareholder equity after various deductions for items likely to have little or no value in a time of stress (e.g. goodwill).

251. In 2012, HBOS recognised impairment losses of £4.3 billion, down almost 40% on the total for 2011, but still around twice the level reported in 2006 and 2007. HBOS reported a small profit of £0.2 billion for 2012.

Analysis of HBOS Group impairments 2008 to 2011

252. As described above, prior to the acquisition by Lloyds TSB in late 2008, HBOS had reported only comparatively small impairments to the market. In its 2008 interim results, for example, HBOS declared total impairment losses of £1.3 billion, an increase of 36% from the first half of 2007.

253. HBOS's losses escalated rapidly thereafter, however, with impairments for the whole of 2008 totalling £13.5 billion, more than ten times the interim number. Even these figures were exceeded in 2009, when annual impairments reached £21.1 billion. From the end of the Review Period in 2008 until 2011, HBOS (as part of the Lloyds Banking Group (LBG)) reported a total of £52.6 billion of credit impairment losses, almost 10% of the Group's banking assets at the end of 2008. The majority of the losses (£44.7 billion(42)) arose on the lending portfolios of the banking divisions. The balance was incurred on securities, primarily in Treasury.

254. Table 2.4 shows the recognised impairment losses of the Group split by division. By far the worst performing divisions were Corporate and International, with £21.9 billion and £15.5 billion of impairments, equivalent to almost a fifth and a quarter of their total loans and advances at the end of 2008 respectively.

255. The Retail Division recognised fewer impairments during this period; just £6.6 billion or 3% of the 2008 loan book.

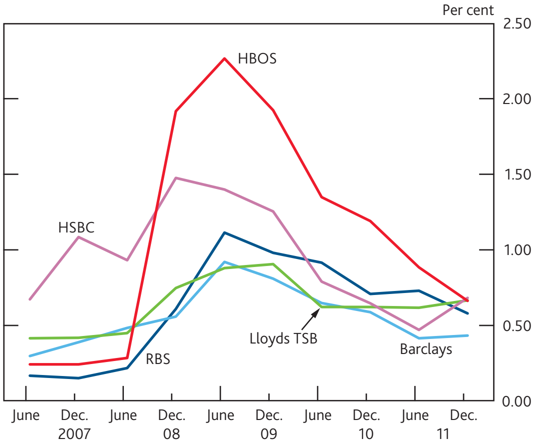
256. There has been limited recovery of HBOS's impairment losses. Between 2008 and 2013, the Group wrote off £39.6 billion of its impairment losses(43) (i.e. 86%) as irrecoverable, while less than 2% (£0.8 billion) were subsequently recovered. Even assuming all remaining legacy loans proved to be good, HBOS would not have survived this level of write-offs absent support from Lloyds TSB and the UK Government.

257. See Appendix 4, Parliamentary Commission on Banking Standards (PCBS) question 1 for an explanation of losses and write-offs.

(42) The aggregate recognised impairment loss on loans and advances in the Annual Reports and Accounts for the period 2008 to 2011 is £45.8 billion. The difference is due to the treatment of impairments on assets transferred from AFS to loans and receivables in 2008. If these assets became impaired after 2008 any residual negative fair value adjustment in the AFS reserve relating to these assets was transferred to the income statement and recorded as an impairment on loans and advances. As these assets were Asset Backed Securities the impairments have been treated as impairments on debt securities for the purpose of this Report.

(43) An impairment loss is recognised when there is objective evidence that a loss event has occurred and is an estimate of the potential loss that may be incurred. Impairment losses are written-off when there is no longer a realistic prospect of recovery and the amount of the loss has been determined (i.e. a real economic loss).

Chart 2.27: Impairment charges as a percentage of loans and advances(a)



(a) Source: *Annual Reports and Accounts* and Review calculations.

Table 2.4: HBOS Group recognised impairments 2008-2011(a),(b),(c)

£ billion	Loans and advances, end 2008(d)	Impairments 2008	2009	2010	2011	Cumulative 2008 to 11	Loss as percentage of 2008 loans and advances
Retail	258	2.2	2.0	1.4	1.0	6.6	3%
Corporate	123	6.7	11.1	3.2	0.9	21.9	18%
International	62	1.0	5.3	5.8	3.4	15.5	25%
Treasury	79	2.9	2.8	0.5	0.7	6.9	9%
Other		0.7	(0.1)	0.0	1.1	1.7	
Total	**522**	**13.5**	**21.1**	**10.9**	**7.1**	**52.6**	**10%**

(a) Source: HBOS reporting to the FSA, *Annual Reports and Accounts* and Review calculations.
(b) The reporting of impairments in this table was not part of the FSA's formal reporting requirements and consequently was on a 'best endeavours basis'. Further, following acquisition by Lloyds TSB, the HBOS divisions were restructured. Consequently the reported losses did not map exactly to HBOS's divisions, pre-acquisition. The Review has therefore, in part, used its judgement to allocate losses to the HBOS divisions. Where it has not been possible to allocate losses to a specific division, they have been classified as 'Other'.
(c) The impairments for Retail, Corporate and International are impairment losses on loans and advances. The Impairments for Treasury are impairment losses on debt securities. The Other impairments are those that are unallocated plus 2008 impairments on Corporate's debt securities.
(d) Gross loans and advances, except for the Treasury Division which includes £76.7 billion of debt securities.

Comparison with Royal Bank of Scotland and other UK banks

258. Useful context on the significant size of HBOS's losses can be gained from making comparisons with other UK banks following the onset of financial crisis, including RBS which also failed during this period.

259. As illustrated by Chart 2.27, while most of the major UK banks faced increasing impairments as a result of the financial crisis, HBOS was a clear outlier in terms of the relative size of losses incurred. This indicates that HBOS had developed a degree of vulnerability which made it uniquely susceptible to the downturn that unfolded. The characteristics of HBOS's lending, particularly its overwhelming concentration in property lending across all its major business lines, and a skew towards riskier exposures in corporate lending, differentiated HBOS's risk profile from the rest of the peer group.

260. Impairment losses on loans and advances experienced by RBS between 2008 and 2011 amounted to £38 billion or 4.5% of its 2008 loan book. This was less than the £44.7 billion impairment losses incurred by HBOS over the same period, at a loss rate of 10%.

261. While RBS's failings and weaknesses included an investment banking operation which lost £17.7 billion in credit-trading activities and the extremely risky acquisition of ABN Amro, HBOS's poor credit quality was sufficient to place the firm under similar and acute capital stress without these additional factors. The losses experienced by HBOS on its commercial property lending were double the rate of those reported by RBS between 2008 and 2011.

262. While the Group claimed to be lower risk than peers at the beginning of the Review Period, by the end of 2008 it recognised that it had a higher risk profile.(44) In short, the financial crisis created issues for all the major UK banks, but the Review's findings are that HBOS's higher risk strategies meant its loan book was more badly affected by the crisis than others.

(44) See Sections 2.4.9, '*Loan impairment losses in Corporate*' and 2.9.3, '*The firm's actual capital positions*'.

2.4 Asset quality – Corporate Division

2.4.1 Introduction

263. The purpose of this section is to consider the nature and quality of the assets and business of Corporate Division. The section is structured as follows:

- Section 2.4.2 provides an overview of the Corporate Division and the strategic choices made by management;
- Section 2.4.3 sets out the financial performance of the division. Specifically the section considers: the reported profitability of the division; the composition of the balance sheet and asset growth; growth in underwriting exposures; and the size and nature of individual counterparties;
- further sections then consider the quality of the division's assets, including: Section 2.4.4 (the rating of the division's lending); Section 2.4.5 (the size and nature of the division's commercial property exposures); Section 2.4.6 (the size of the division's equity investments); and Section 2.4.7 (the size and nature of the division's leveraged lending);
- Section 2.4.8 considers what stress testing was undertaken on the portfolio by the division during the Review period. It also includes high level analysis undertaken as part of the Review to illustrate the magnitude of losses that could have been predicted using the prevailing data; and
- finally, Section 2.4.9 considers the £21.9 billion of losses that the division incurred in the years 2008 to 2011, linking these losses to the specific features of the division.

2.4.2 Divisional strategy

Divisional structure

264. The Corporate Division was created following the merger of Halifax and Bank of Scotland in 2001. It was the amalgamation of the corporate banking arms of the two banks, although it substantially comprised the corporate business of the Bank of Scotland, as Halifax had minimal corporate banking activity. The principal brand through which the division operated was 'Bank of Scotland Corporate'.

265. The target business of the division was mid and large-sized businesses with turnover of greater than £1 million. A separate Business Banking Division was created to lend to smaller businesses, although this was substantially integrated into the Corporate Division in 2004. In 2005, certain of the division's international activities were transferred to the International Division: nevertheless Corporate continued to pursue international lending outside International Division, and in mid-2007 the European business of the International Division was transferred back to Corporate.

2

266. In 2006, the division was reorganised to promote specialism in its core markets. By the end of 2007, the division operated through six business units. Integrated Structured and Acquisition Finance (ISAF) focused on management and private equity leveraged buy-outs across the United Kingdom and continental Europe, providing both debt and equity; Specialised Industry Finance (SIF) targeted social infrastructure projects (e.g. Private Finance Initiatives), the oil and gas, telecoms and media, transport and renewable power sectors; Joint Ventures (JV) provided integrated funding (i.e. debt and equity), with a focus on house builders, pubs and hotels; Asset Solutions provided a range of specialist asset finance solutions in the United Kingdom (e.g. leasing, contract hire); Real Estate (RE) provided debt funding for property investors, developers and house builders; and Commercial provided a range of banking services (e.g. bank accounts, overdrafts, money transmission services) to businesses with turnover greater than £1 million. JV and RE were the predominant lenders on commercial property, though ISAF also lent to companies in the property sector.

Table 2.5: Total assets of the Corporate Division by business unit[(a),(b)]

£ billion	2006	2007	2008	Growth 2006 – 08
Commercial	22	26	25	14%
Real Estate	28	32	34	21%
JV	11	16	18	64%
ISAF	8	15	17	113%
Asset solutions	10	10	8	(20%)
SIF	15	18	23	53%
Other	7	6	7	–
Total	**101**	**123**	**132**	**31%**

(a) Source: Corporate Division management accounts.
(b) Total assets includes: loans and advances, investment securities and leased assets. It does not include non-operating assets.

Markets and products

267. Given the division's BoS heritage, it had a substantial share of the Scottish relationship banking market. In its business plans, the division estimated this share as 37%. Across England and Wales, it had an estimated market share of about 3% and in aggregate about 5% of the UK market. The market share for England and Wales had only marginally increased in the years since the merger, despite a clear strategic aim to make inroads in these markets.

268. BoS had a significant share of the UK commercial property market (around 20% of outstanding loans issued by the major UK banks) at the time of the merger, which was maintained under HBOS in part as a means of achieving growth: '*The immediate push post-merger had been focussed excessively on "quick-wins" – and had largely become focussed on commercial property*'.[(45)]

269. The Corporate Division sought to provide an extensive range of services: senior lending; junior lending, including the provision of equity, mezzanine and subordinated debt finance; asset finance; working capital; and banking and treasury services.

(45) HBOS ExCo away day minutes, June 2006.

Divisional philosophy, risk appetite and objectives

270. The objectives of the Corporate Division were broadly unchanged over the Review Period:

- to preserve or grow market share to between 15-20% in its core markets, in particular to expand the division's business banking presence in England and Wales, and to be a challenger to HSBC, Barclays, Lloyds TSB and RBS;
- to reduce the already low cost-income ratio, and to use this as a competitive advantage – this ratio was a source of pride to the Group and it was active in seeking to reduce it further; and
- to achieve double digit profit growth, but with a shift towards non-interest income to relieve pressure on margins.[46]

271. Following the 2001 merger, the aim was to grow aggressively and become the '*new force in banking*' challenging the established status quo. The increased balance sheet size of the merged entity allowed the division to undertake larger deals and to take the role of lead underwriter, a part of the market previously closed to it.

272. In 2004/05, the division's stated strategy changed as the merger synergies were largely exhausted and there was some evidence of softening UK demand. The stated position became one of measured or controlled growth, albeit one in which the division would still pursue opportunities, especially in the core markets of the Group, within which there was the perception that the firm could derive value from its experience and deep knowledge of markets. The underlying objective of 20% market share in the division's core markets remained, however.

273. The stated approach in the 2006 published financial statements was:

- selective asset growth: a more focused approach in selected markets where the division had experience and knowledge;
- controlled credit risk: to allow the division to add to sectors where it was already a market leader and support strong growth in other markets; and
- cost leadership.

274. The often-quoted approach of the division was to be a relationship bank that would 'lend through the cycle'. Elsewhere the division's approach had been called 'counter-cyclical'. This was described as standing by and supporting existing customers through difficult times, while continuing to lend to those good opportunities that could be found. The division claimed it had a deep knowledge of the customers and markets in which it operated, which would enable it to pursue this approach with minimal threat to the Group. It was an approach that was felt to have served BoS well in the early 1990s downturn.

275. This belief was misguided as the division and market had both changed since the early 1990s, as noted by Group Credit Risk Committee in August 2008: '*There are difficult workouts and the integrated model is severely challenged as this is the first time it has been tested in an economic downturn*.' Furthermore, any bank that operated a through the cycle approach required resilient and robust capital, funding and liquidity to enable it to absorb increased costs and losses in any downturn.

(46) Average interest rate margins for investment loans across all sectors declined between 2002 and 2006 (De Montfort Review); e.g. prime office space declined from around 120 basis points to around 95 basis points. Similarly margins on projects also declined between 2003 and 2006.

276. The philosophy associated with 'lending through the cycle' and 'supporting our customers' created a culture conducive to continued lending. So, even as there were general moves at Group level to restrain asset growth in late 2007 and early 2008, this did not filter down to the bank's property lending activities until too late.

277. A number of features of the division's approach are of note as being high-risk:

- a risk appetite for speculative lending (Section 2.4.4);
- an integrated lending model in which the division would provide a one-stop shop of mezzanine and equity to firms, in addition to traditional senior debt and working capital (Section, 2.4.6,);
- an originate-to-distribute model under which the division accepted the full risk of a transaction before seeking to distribute it in whole or part to a third party (Section 2.4.3); and
- a desire to increase the size of deals and support for individual businessmen (Section 2.4.3).

278. Further explanation of the division's strategy and approach can be found in Part 3, Section 3.5.2, '*Management and governance failings in relation to the Corporate Division*'.

2.4.3 Performance

279. The Corporate Division represented just under a fifth of the Group's balance sheet at the end of 2007. This was about half the size of the Retail Division but over one and a half times the size of the International Division. However, over the Review Period, the profits of Corporate represented a larger share of overall Group profitability. Before 2007, Corporate contributed around 28% of the Group's profits but this jumped to over 40% in 2007, when Corporate replaced Retail as the largest contributor to Group profits.

280. With its net interest margin broadly declining over the period due to competitive pressures, the division managed significantly to increase its non-interest income from £1.5 billion in 2004 to £2.7 billion in 2007 while maintaining low growth in operating costs to improve its profitability.

281. Two significant contributors to non-interest income in 2007 were disposal profits on the division's investment securities and revaluations on the equity stakes in the JV business unit, in total £0.7 billion, both of which had grown considerably since 2005. However, these were not good quality sustainable earnings upon which reliance of future profitability should have been placed, particularly in a recession. In 2008, these items contributed a loss of £1.6 billion to the division as liquidity dried up and investor appetite waned. In total, the division reported a loss of £2 billion on its investment portfolio.

282. The division's cost-income ratio was considerably lower than for the Group as a whole, in part as it did not have to support a branch network. It was a low ratio compared to the corporate and commercial businesses of other large UK banks, and fell in the period, partly due to insufficient investment in systems and controls relative to risk.

283. As the crisis took hold in 2008, impairments rose significantly, causing a pre-tax loss in the division of £6.8 billion. The magnitude of this loss was more than sufficient to wipe out the total pre-tax profits of £6.6 billion made in the years 2004 to 2007.

284. The income statement and balance sheet for Corporate in the last five years of its life are shown in Table 2.6 and Table 2.7.

Table 2.6: Corporate Division summary income statement 2004-2008[(a),(b),(c)]

£ billion	2004	2005	2006	2007	2008
Net interest income	1.3	1.7	1.9	2.1	2.3
Non-interest income					
Fees and commissions	0.6	0.3	0.3	0.4	0.4
Trading income	0	0	0	0.1	(0.6)
Associates and joint ventures	0.1	0.1	0.2	0.2	(1.0)
Other	0.8	1.1	1.3	2.0	1.6
Operating expenses	(1.1)	(1.3)	(1.6)	(1.9)	(2.1)
Impairment loss on loans and advances	(0.4)	(0.5)	(0.4)	(0.6)	(6.7)
Impairment loss on investment securities	0	0	(0.1)	0	(0.7)
Profit before tax	**1.3**	**1.4**	**1.6**	**2.3**	**(6.8)**
NII margin (%)	2.26	2.15	2.22	2.06	1.92
Cost-income ratio (%)	30.80	28.70	28.90	23.20	115.20
Impairment loss/loans and advances (%)	0.58	0.56	0.52	0.61	5.89
Return on assets	N/A	1.7%	1.8%	2.1%	N/A

(a) Source: HBOS *Annual Reports and Accounts* and Review calculations.
(b) 2004 is the comparative in the 2005 *Annual Report and Accounts* to reflect the move to IFRSs in 2005.
(c) Return on assets refers to underlying profit before tax divided by average assets (based on the year-end position).

Table 2.7: Corporate Division summary balance sheet 2004-2008[(a),(b),(c),(d)]

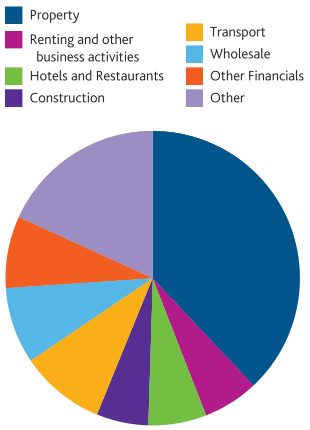
£ billion	2004	2005	2006	2007	2008
Total assets, including:	82	87	97	122	128
Loans and advances	73	79	85	109	116
Investment securities	3	2	3	5	4
Lease assets	3	3	5	5	4
Undrawn commitments	N/A	N/A	N/A	38	31
Risk weighted assets	86	93	101	129	172
Deposits	39	42	39	44	39
Impaired loans/loans and advances (%)	1.9	1.4	1.3	2.9	11.9
Impairment provisions/impaired loans (%)	53	63	63	26	47

(a) Source: HBOS *Annual Reports and Accounts* and Corporate Division management accounts.
(b) Impairments as a percentage of loans and advances in 2007 are as reported in the 2008 *Annual Report and Accounts*. An explanation of the magnitude of the ratio is provided in Section 2.4.9.
(c) Net of impairment provisions.
(d) Risk weighted assets were calculated under Basel I until 2007 and under Basel II in 2008.

285. Chart 2.28 shows the overall composition of the portfolio by drawn balances as at September 2008. The largest sectoral exposure was to property at £46 billion, representing 38% of the balance sheet. Taking into account renting, hotels and construction, the firm's overall exposure to property and related assets increases to £68 billion or 56% of the portfolio. The Corporate Division's lending to commercial property is discussed in more detail in Section 2.4.5.

2

Chart 2.28: Corporate Division – portfolio composition September 2008[a]



(a) Source: Corporate Division, Credit Risk Committee: Portfolio Risk Reports.

Asset growth

286. Following the merger in 2001, the Corporate Division pursued rapid growth as did the rest of the HBOS Group.

287. The division actively sought to slow net asset growth around the beginning of the Review Period, due to concerns that the economy was reaching a peak and competition was having a detrimental effect on margins and deal structures. Actual growth rates did fall (Chart 2.30).

288. At this time, market liquidity was good and churn high, which meant that loans were quickly redeemed or the division was able to sell-down unwanted loans. If anything, the rates of churn gave rise to concerns that assets were reducing too quickly and the division would find it hard to achieve its desired net asset growth.

289. Churn was estimated at around a third (i.e. a third of the book was being redeemed each year), which meant the division needed to lend £25 billion to £30 billion per annum merely to stand still.[47] Moreover, the division's revenue was primarily derived from its lending activities, notwithstanding an aim to increase non-interest income. Net asset growth was therefore a prerequisite to meet revenue and profit growth targets. There was a very strong motivation to lend and lending gained a strong momentum as the division developed strong asset origination processes.

290. In the absence of the anticipated downturn, decisions were taken in 2006 and 2007 that halted the slowdown in asset growth, causing it to rise. In June 2006, ExCo debated the preferred rate of growth for 2007 to 2011 given the '*present growth plans were relatively pedestrian*'. The outcome was to increase the target underlying profit before tax for 2007 and consequentially the rate of asset growth. This also implied a step change in approach, as asset growth depended upon being able to originate larger deals and strengthening distribution capability. In late 2006, the division increased its net asset growth targets for 2007 due to improved optimism about the economy. The decisions also resulted in a final growth rate for 2006 of 9%, higher than the proposed 6% in the Group Business plan 2006 – 2010, that was produced in 2005.

(47) Churn was also desirable as it generated refinancing fees while allowing fees to be recognised earlier than if the loan was redeemed at term, as noted in the Corporate Division Business Plan 2006 – 2010: '*We are dependent on a continuing high rate of churn …to generate the refinancing opportunities we need to deliver the high rate of non-interest income…*'.

291. By early 2007 there were again indications that the economic cycle had reached a peak and a downturn could be expected, but in mid-2007 profit targets were increased to compensate for the slowdown in Retail profitability, so giving further impetus to growth.(48) Moreover, there seemed a concern that Corporate would not achieve its year-end asset growth targets, which gave rise to proposals that considered delaying sell-down and targeting North America and Europe for further growth. More generally, ExCo concluded there was scope for strong growth in Corporate in the next 18 months.

292. In late 2007 as the crisis began to escalate, the messages became mixed: the division would be more selective and would focus on existing customers, and sanctioned(49) amounts did reduce from mid-year 2007 (Chart 2.29). However, there was a fear of damage to the franchise value of the division from reducing lending too quickly, and growth targets for 2008, initially set out in September 2007, were maintained when the Board signed off the Group plan in November. Notwithstanding the reduction in sanctioned lending, the proposed growth rate for loans of 10% for 2008 was 1% more than the Group had planned for 2008 when signing off the business plan in 2006 (i.e. the 2007 – 2011 Business Plan). Chart 2.32 also suggests that the desire to focus on existing customers did not happen, as the Executive Credit Sanctioning Committee approved as much high value business for new customers as for existing.

293. The BoS 'through the cycle' lending philosophy and a belief that property lending was safe, also contributed to strong lending late in the cycle. So the division was still looking to grow in late 2007 after the market had turned: '*As others withdraw from the market we see this as an opportunity to seize market share … This is underlined by strong projected advances growth in 2007 and beyond*'.(50) In the December 2007 Board MI, the CEO report presented deal flow as one of the big challenges for the division in 2008 as '*the market is currently very quiet*', while in February 2008 the Group Executive minutes recorded that there was '*There was ample desire to pursue transactions, but other 'like minded' banks were required in order to complete deals*'.

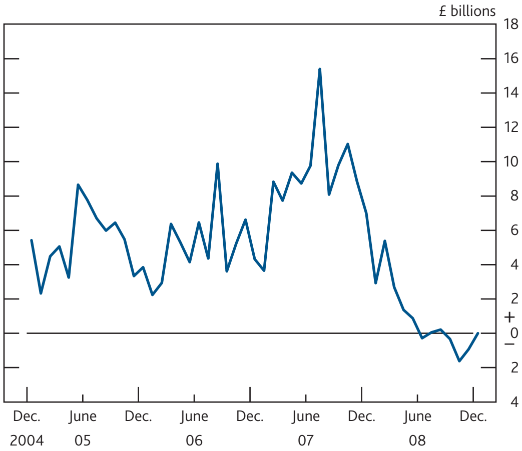
294. Divisional MI indicates almost £80 billion was lent in 2007 while £60 billion was repaid. Sanctioned lending amounts were even higher: MI suggests £108 billion of new business was sanctioned in 2007, almost £50 billion more than in 2005 and 2006. Moreover, the division was increasingly willing to lend ever larger amounts (Chart 2.29 and Chart 2.32) and, as much of the lending was also leveraged (Section 2.4.7), in the Review's opinion there was an overall increase in the risk profile of the division.

295. As market liquidity dried-up from August 2007, the division found it could no longer sell down the loans it wanted to, which was not helped by a weak loans distribution function. Churn and redemptions slowed dramatically and borrowers increased their draw-down of committed facilities. As a result, the division experienced 22% actual loan growth in 2007 (Chart 2.30), considerably overshooting the 10% planned growth. The amount lent had increased to £109 billion rather than the planned £99 billion.

(48) The division was asked to increase its profit for 2007 to 135% of the 2006 figure.
(49) There are a number of stages to the lending process. Sanctioned lending reflected an initial amount the division was willing to lend. It did not represent a contractual agreement with the borrower. Further negotiations took place between the division and borrower before a contractual facility agreement was signed, setting out the size of the facility (this need not be the total amount sanctioned) and terms of lending. The formal contract created a contractual commitment for the division to lend monies to the borrower. Loans and advances and assets on the balance sheet are the drawdown of monies under the contractual agreement. The undrawn amounts of the loan facility are off-balance sheet contractual commitments of the division.
(50) Bank of Scotland Corporate Business Plan 2008-2012.

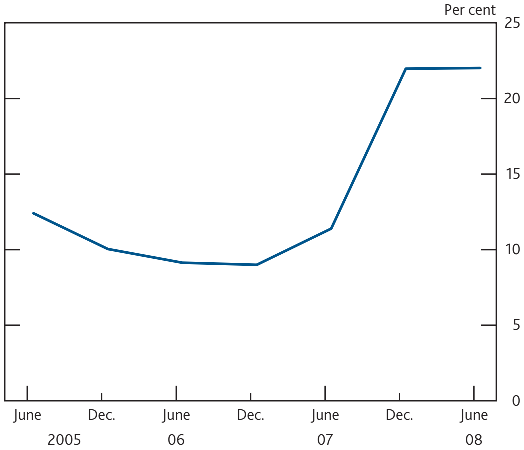
2

Chart 2.29: Sanctioned new lending for new and existing customers, per month[(a)]



(a) Source: Corporate Division, Credit Risk Committee, Credit Sanctioning Reports.

Chart 2.30: Annual growth rate of loans and advances (drawn balances)[(a)]



(a) Source: HBOS *Annual Reports and Accounts* and Review calculations.

296. In early 2008, the growth aspirations of the division were moderated[(51)], sanctioned lending continued to fall and new business decline rates[(52)] increased (from less than 10% per month to over 20% on average between March and October 2008). However, the committed limit continued on the same upward trend in early 2008 as in late 2007, as previously sanctioned amounts progressed through to commitments to lend. The growth in commitments finally ceased around March 2008, although the actual drawn amounts continued to grow (by £5 billion between March and November) as borrowers drew down on the committed facilities (Chart 2.31).

297. The onset of the crisis revealed the weakness in the division's 'asset led' lending model (i.e. asset reduction lagged asset growth). In 2007, as the market dynamics changed, new asset growth significantly outstripped redemptions and sell-downs. This increased the funding pressures on the Group as a whole. It also left the division with considerable loans advanced at the height of the market when there was downward pressure on margins and covenants, and increased leverage and LTVs. This exacerbated the risk in the book and left it more exposed to the downturn.

298. The rapid growth in loans in 2007 also highlighted underlying weaknesses in the capacity of front-line systems and controls, as the number of unreconciled items in the division's Loans Management System doubled to 12,000 due to an inability to cope with new and more complex loans.

299. As the Head of ISAF said to the *Sunday Times*, '*what we didn't do was put the foot on the brake* [in ISAF] *in 2007'*. Other HBOS employees have drawn analogies between the momentum of Corporate's lending and the difficulties in stopping oil tankers.

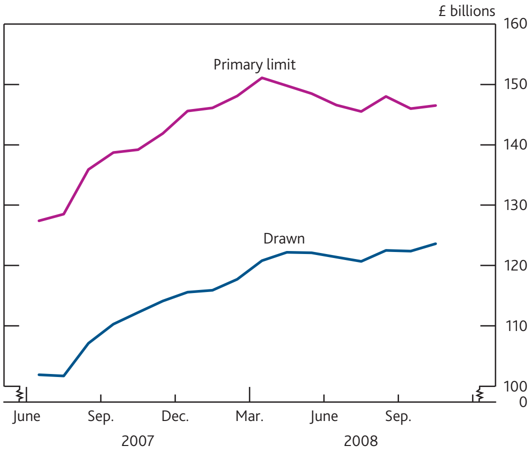
Originate-to-distribute model

300. Corporate's vulnerability to unplanned asset growth was aggravated by its 'originate-to-distribute' lending model.

(51) The Q1 forecast presented to the Board in April 2008, updating the Group Business Plan 2008 – 2012, presented in November 2007, proposed reducing the 2008 loan growth rate to 8.5% from 10% and the 2009 rate to 4% from 10%. The revised plans had been presented to ExCo in March 2008.
(52) The proportion of applicants turned down for a loan.

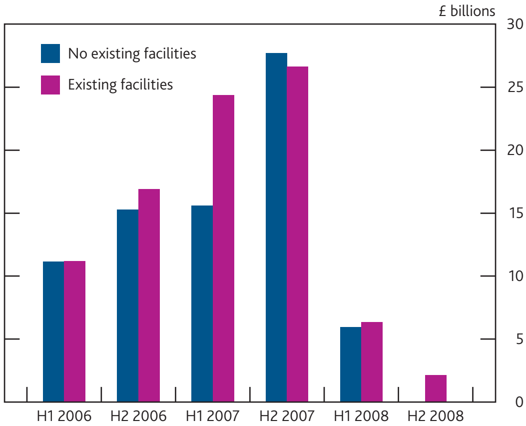
2

Chart 2.31: Primary committed limits and drawn balances outstanding(a)



(a) Source: Corporate Division, Credit Risk Committee Portfolio Risk Reports.

Chart 2.32: New facilities greater than £75m approved by the Executive Credit Sanctioning Committee, 2006 to 2008(a)



(a) Source: HBOS Group Board packs.

301. The Corporate Division tended to operate as sole lender. However, for a number of exposures it looked to sell-down or syndicate part of the exposure. The division's approach was to underwrite fully any deal itself, determine an amount that it would like to hold, and then seek to sell down the risk it did not want at a later date. This differed to other forms of syndications, where the deal arranger would seek firm commitments from other parties at the time of the origination. HBOS also typically looked to retain around 40% of the loan, whereas others looked to substantially distribute the amount underwritten, and especially when underwriting leveraged loans, so retaining very little risk.

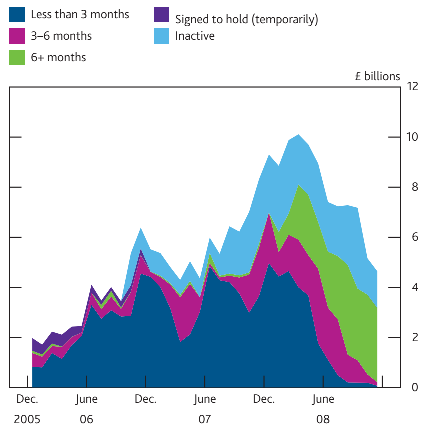
302. The division therefore ran significant risks related to its ability to sell down, the timing of the sell-down and the price that would be achieved. Holding the loan for an extended period increased the credit risk faced by the firm. Furthermore, the total loan underwritten needed to be funded until sell-down, thus also increasing funding and interest rate risk. A less risky approach would have been to do the underwriting and syndication hand-in-hand; the deal arranger knows at the time of entering into the deal that it will be able to pass off part of the risk exposure and funding.

303. The risk was further exacerbated by HBOS's systems and processes. The function responsible for the sell-down or distribution of loans was located within Corporate.[53] It lacked authority to veto poorly priced deals and did not have the same level of capital markets expertise or authority as other banks. Mr Peter Cummings (the Chief Executive of Corporate) noted in interview: '*We effectively, within the division, did not have capital markets platform, if you like. As an organization, it is simply because of our history as a smaller regional bank.*' At the time of entering into a deal, the loans distribution function would be asked to give a recommendation on its ability to subsequently sell-down, taking into account the proposed price. However, the function's views were often ignored when it identified potential difficulties to selling down, as it was not mandatory for the business to act on its recommendations.

304. The approach adopted by the division brought increased revenues through taking a greater share of the fees and commissions and allowed transactions to be completed more quickly, as there were no syndicate members to be consulted before agreeing to the loan. However, this made each loan significantly more risky.

(53) This department was transferred to the Treasury Division in 2008.

Chart 2.33: Corporate Division – monthly amounts outstanding by age of underwritten loans pending sell down[a]



(a) Source: Corporate Division, Underwriting Exposures Return and Review calculations.

305. The division's experience in 2006 also influenced the accounting, enabling earlier recognition of the income to the income statement.[54] Fees receivable on underwriting a loan were initially recognised in income over the life of the loan, akin to interest. In 2006, the division was able to sell-down exposures relatively cheaply (i.e. it was not having to pay away the fees it had received on the initial underwriting). As a result, the fees receivable were rebadged as commission income rather than interest and were recognised on underwriting rather than over the life of the loan or on sell-down. This meant that the revenue benefits of the approach could be recognised upfront, with the risks and costs deferred. It seems likely that the positive experience in 2006 contributed to a perception that this was a low-risk model and encouraged its continued use and expansion past the point that the market had turned, when sell down was no longer possible at the price and low costs achieved in 2006.

306. Separating loan origination and sell-down also removed a constraint on loan growth, and allowed sales staff incentivised by asset growth and fee income to pursue further deals.

307. The resultant risks began to crystallise in 2007, contributing to HBOS's unplanned asset growth of 22%. The 'originate to distribute' model became an enforced 'originate and hold'. This put added pressure on the funding of the Group, while leaving it with a larger balance sheet exposed to losses in a downturn.

308. The profile of the outstanding underwriting amounts awaiting sell-down is shown in Chart 2.33. Up until early 2007, the amount outstanding was growing as the division grew, but the age of the outstanding amounts did not increase, typically remaining less than three months.

309. From mid-2007 the position changed. Lending continued into 2008[55] but with the secondary markets starting to close, the division did not achieve the desired sell-downs. In part, this was market-driven but also it appears that the division's deals were poorly structured (i.e. too much leverage and equity) with insufficient margin to make them attractive to secondary investors. There had been an early warning of this risk in the sell-down of a significant deal in late 2006 and early 2007: while the division was successful in selling down its unwanted portion, 55 potential buyers had declined due to the structure of the deal.

(54) The Corporate Division Business Plan 2007-2011, refers to sell-downs being achieved cheaply and therefore a greater proportion of fees are being badged as underwriting, leading to a switch from interest income to commissions. This implies earlier recognition of fee income as it is no longer spread over the life of the loan.
(55) £2 billion was underwritten in February and March 2008.

310. The value of outstanding loans reported in internal management information peaked at £10.1 billion in March 2008, after which it declined to £4.6 billion by November 2008 (Chart 2.33). The fall was substantially due to the transfer of exposures to a 'hold for future sale' category reflecting an acceptance that there was no immediate prospect for sale. By the end of November 2008 £4.6 billion was being reported as 'hold for future sale' rather than as outstanding. In aggregate the division had over £9 billion of exposures that were essentially outside its risk appetite.

311. A significant number of deals entered into in 2006 and 2007 subsequently encountered difficulties.

Large exposures

312. Another important trend of the Corporate portfolio during the Review Period was the increasing exposure to a number of large individual borrowers, in particular as a result of actively supporting chosen businessmen or entrepreneurs. In many transactions, the exposure also involved commercial property and/or equity and mezzanine debt and/or was highly leveraged, so further increasing the level of risk. There were also a number of connections between the exposures. The size of these exposures meant default would have a high impact.

313. The merger of Halifax and BoS was the original catalyst for deals of increasing size, as the division was able to utilise the combined Group's much larger balance sheet. It is the Review's opinion that the division's low cost-income ratio and the desire to maintain this acted as a further driver towards larger deals. It was easier to grow deal size, rather than volume or to diversify, where there were cost constraints on developing the infrastructure platform to support growth.

314. In September 2002 the largest sanctioned facility was marginally less than £1 billion, and only four facilities were larger than £500 million.

315. The division's internal large exposures report shows that at the end of 2005, the division's top 30 exposures accounted for 15% (£19.2 billion) of the value of the portfolio. Only two exposures were greater than £1 billion, the largest being £1.7 billion. By the end of September 2008, however, the top 30 exposures represented 21% (£30.9 billion) of the portfolio. The largest exposure was £1.8 billion and there were fourteen exposures in excess of £1 billion.

316. It appears that the division was prepared to lend even larger amounts than these. The Corporate Executive Credit Sanctioning reports included sanctioned facilities closer to £3 billion. In September 2008, there were two facilities whose approved amounts were £2.9 billion and £2.4 billion.

317. The division's largest exposures were disproportionately exposed to commercial property. Four of the five largest exposures, totalling £6.4 billion, were property related; and fifteen of the top 30 exposures were predominantly property related while another five included significant property lending.

318. The top 30 exposures included a number of individual high-profile businessmen. Many of these had been customers of the division for many years, some going back to the BoS pre-merger. True to the division's banking philosophy, it had supported these customers as they grew and expanded their businesses. However, business growth and expansion sometimes meant a change in business model to become significant property investors; not necessarily the original core business and expertise of the borrower. In the crisis, a number of these businessmen, though not all, incurred losses on their property investments. As Sir Tom Hunter was reported as saying in May 2013: '*We*

made huge mistakes. Our mistake was we lost our focus and we began to get into things that we were not focused on, sectors that we did not quite understand and that was totally my mistake'.(56)

319. The connections between the firm's various exposures could also be complex and entwined. In 2006, HBOS led a consortium to buy out McCarthy and Stone, a construction company. The consortium included the Reuben brothers and Sir Tom Hunter. In 2004, these same partners, along with Prestbury had acquired a portfolio of 220 pubs and later in 2004 they acquired Travelodge. In 2006, HBOS and Sir Tom Hunter acquired Crest Nicholson; and they were jointly bidding for Wilson Bowden in early 2007. But at the same time as investing alongside its business partners, HBOS was also lending substantial amounts to them. The consequences of a web of inter-connections are an increased potential for contagion within HBOS's portfolio, a significant reduction in the transparency of risks and a further concentration of the risk in the event of a downturn.

320. In the period from 2008 to 2012, fourteen of the division's top 30 exposures as at September 2008 – amounting to £15.5 billion – had their debt restructured (for example, by entering into a debt for equity swap), went into administration or otherwise experienced difficulties. Twelve of these exposures were predominantly property or had a significant property component.

2.4.4 Higher-risk speculative lending

321. The Corporate Division's appetite for higher-risk and speculative lending was a key feature of its business approach.

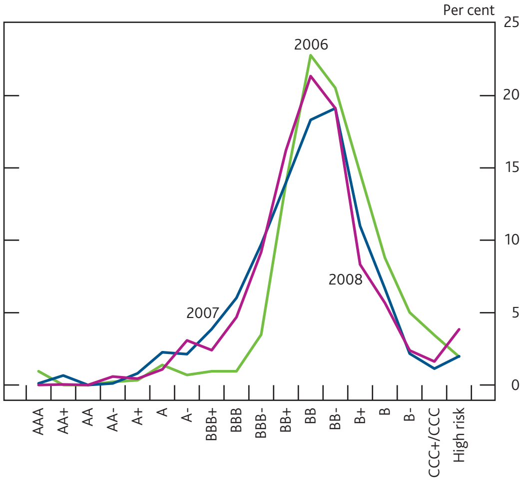
322. Corporate did not typically lend to blue chip or publicly-rated companies and the majority of its exposures were not individually rated by rating agencies. Nevertheless, the firm had its own internal ratings systems, which rated the majority of the division's exposures. The division had a portfolio target rating of 5.2, which mapped to a Standard and Poor's (S&P) rating of BB, i.e. it was sub-investment grade lending. However, the average reported rating for the portfolio during the period 2006 to 2008 was just 6.1 (or B+).

323. Despite a marginal improvement through 2007 and 2008, the division's rating distribution remained skewed to lower quality ratings (Chart 2.34) with around three quarters classed as sub-investment grade.

324. HBOS was an outlier compared to the other major UK banks operating in the UK corporate sector in taking on higher-risk assets. Chart 2.35 shows the distribution of the estimated probability of default for HBOS and other significant UK corporate lenders. This indicates HBOS had a significant bias towards assets with a higher likelihood of defaulting. It appears this was intentional, as the Corporate Credit Risk Committee (CCRC) minutes recorded: '*…it was agreed that our book will be of lower quality due to the size of the companies we deal with compared to our peers…*' In December 2008, the Board noted the potential crystallisation of this: '*It was believed that the Lloyds Corporate performance was coming under pressure – but not at the rate of the HBOS book – in part due to the positioning of the HBOS book at a more "exposed" section of the risk spectrum, as well as concentrations in sections that were under particular pressure*'.

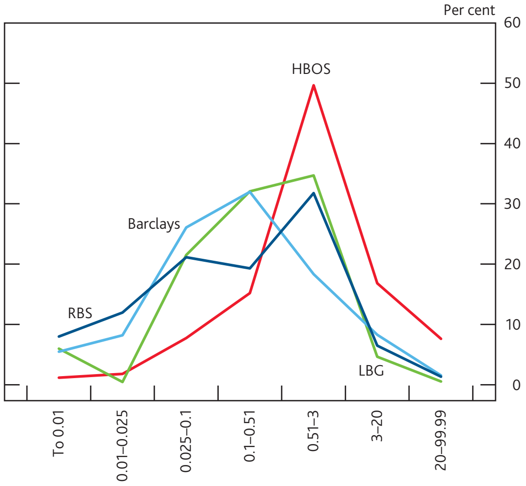
(56) Reported in the *Herald Scotland*, 10 May 2013.

Chart 2.34: Ratings for Corporate Division exposures[(a)]



(a) Source: Corporate Division portfolio data and Review calculations.

Chart 2.35: Probability of default distribution for corporate exposures, 2008[(a),(b),(c)]



(a) Source: *Basel II Pillar 3 Disclosures 2008* and Review calculations.
(b) The corporate exposures included within the pillar 3 disclosures are those for which a firm has received regulatory approval to use its own internal models for its regulatory capital calculations.
(c) The probability of default (pd) is the likelihood that a customer will default on his obligations.

325. Prior to 2007, it was not clear that the target rating for the portfolio played a significant part in HBOS's credit-sanctioning process, as the various minutes seem to record matters that could be used as arguments to ignore the metric. In September 2006, the CCRC minutes recorded: '*… that the weighted average risk rating of 6.1* [ie B+] *quoted in the report was as a result of the exponentiality of the PD curve. On a linear basis the weighted average is 5.2.*' Elsewhere it was recorded that the expected loss was better, that the division was getting higher margins or that large deals distorted the average.

326. The minutes also consistently recorded that new business was of 'better quality', despite the reported average probability of default on new lending showing very little improvement until late in the Review Period. Eventually the CCRC minutes ceased to record that the average portfolio rating was below target, and while the aim to improve credit quality remained, the fact that this was not being achieved did not seem to warrant any concern in the minutes.

327. Other reasons for the apparent limited attention given to shifting the portfolio average weighting are: the rating system in place prior to the use of Basel II models from mid-2006 delivered a higher rating; and the Group consistently expressed the view that the FSA imposed too much conservatism to Basel models.

Table 2.8: HBOS internal ratings mapped to S&P classification[(a)]

HBOS internal rating	S&P rating	Associated probability of default
5.1	BB+	0.45% – 0.70%
5.2	BB	0.70% – 1.475%
5.3	BB-	1.475% -2.73%
6.1	B+	2.73% – 5.805%
6.2	B	5.805% – 10.21%
6.3	B-	10.21% – 17.67%

(a) Source: HBOS Board packs.

328. By knowingly accepting lower-rated exposures, the division left itself more exposed in the event of a downturn. Lower-rated credits are historically affected proportionately more by a downturn than high-rated credits, which is reflected in the non-linear relationship between ratings and the probability of default (see Table 2.8).

329. In a review of Corporate's Basel II credit risk models, the FSA considered the models to rank order appropriately, but was concerned that the ratings for the best and worst exposures would not be sufficiently dispersed around the average rating. This meant that the firm would potentially underestimate how bad some of its loans were but also how good others were. With the average skewed towards lower quality ratings, and the non-linear relationship between probabilities of default, this would have a further negative impact on the portfolio.

2.4.5 Commercial property

330. Another key feature of Corporate's business approach was its significant focus on commercial property. Historically, commercial property lending has been a frequent source of distressed assets and losses within the banking industry, notwithstanding that property lending is secured. Its performance is cyclical and strongly linked to that of the wider economy, through the impact of unemployment and consumer spending on occupancy rates and rentals, and demand for new builds.

331. Throughout its history, HBOS always had a significant exposure to commercial property in its Corporate, International and Treasury[57] Divisions. The Corporate Division had the largest exposure. As at November 2008, it had commercial property or property-related lending of £68 billion, and a further £8 billion of undrawn commitments.

332. The division's property lending comprised over 50% of its total portfolio throughout the Review Period. A large part of the portfolio had been lent at the height of the economic cycle and was to higher risk segments such as construction, while the average portfolio rating was B+. Finally, controls around security were weak. Given the magnitude of the division's commercial property lending, it was therefore highly vulnerable to any economic downturn.

333. Over 90% of the division's property portfolio was invested in UK property and it represented a significant percentage of the UK market. The division had also gained a large European portfolio built up following the UK approach – by providing integrated funding packages, leveraged deals and focusing on key individuals.

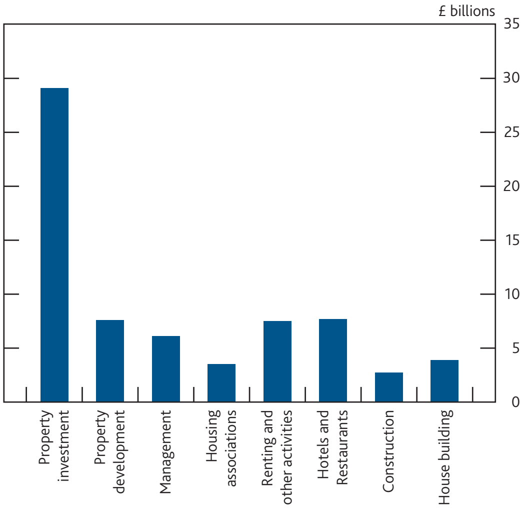
A large and concentrated portfolio, with significant high risk elements

334. The majority of UK banks had large exposures to property, including commercial property. However, HBOS by its own determination had one of the largest concentrations within its portfolio. Analysis by the firm in 2007 showed that 40% of the book was commercial property against a sector average of 23%.[58] The firm recognised that it had a concentration to property but regarded the concentration as 'moderate'.

335. Not only was the division concentrated in terms of its own portfolio but the risk was exacerbated by the large size of the market share held by the firm and the nature of the market. Measures of the aggregate size of the UK commercial property market vary but indicatively the division had a share of around 20 to 24% of the market during the Review Period, second only to RBS.

(57) The Treasury Division held Asset Backed Securities where the underlying assets were property loans.
(58) The firm had a narrower definition of property lending than used by the Review; for example HBOS did not include restaurants, construction companies and house builders in its definition.

Chart 2.36: Analysis of property and property related exposures, showing drawn balances as at November 2008[a]



(a) Source: Corporate Division, Portfolio Risk Reports.

336. With few players in the market, and given the size of HBOS's exposures, there was limited capacity and liquidity to absorb any retrenchment by the firm (i.e. refinancing of loans as lenders looked to leave the market). Moreover, if a number of players looked to exit at the same time, there would be further pressures on the market, so exacerbating any fall in prices.

337. Corporate Division's commercial property and property-related exposures are further detailed in Chart 2.36. While the majority of the division's exposures were to what the division generally regarded as the less risky segments (i.e. property investment, property management and potentially – given limited historical experience for this asset class – Housing Associations), it also had significant exposures to the higher risk segments of construction, house building[59] and development, totalling £14 billion. Moreover, £2.1 billion of this property development was considered purely speculative (i.e. the build was without any form of pre-sale or pre-let in place). Lending to house builders was also predominantly secured against risky assets, such as land banks and work in progress.

338. The construction industry has been badly affected by the crisis with numerous small and large companies getting into difficulties. HBOS's exposures were across the spectrum: the ISAF and JV businesses provided debt and equity to the larger national construction companies, while the Real Estate business lent to smaller and regional borrowers.

339. Pubs and hotels were badly affected by the downturn, and in the case of pubs, also by a longer term shift in consumer behaviour. A number of large pub chains lent to by HBOS got into difficulties.

340. Corporate's property investment portfolio can be further split between residential investments (around £2.5 billion)[60] and commercial investments (around £26 billion). Within the commercial investments, a significant component of HBOS's lending was against property considered to be secondary or tertiary in nature, including:

- sub-investment grade rental streams: the division had some concentration in terms of the tenants underlying its property investment portfolio. While a number of the top ten names

(59) HBOS regarded lending to house builders as low risk given the long term structural under supply of houses in the UK.
(60) Included within the residential investments were some significant buy-to-let portfolios, including two that subsequently went into administration.

represented sound credits, around 65% of total rental income was generated by sub-investment grade tenants; and

- healthcare: the division had exposures to a number of healthcare groups, representing four of its top ten rental streams and 5.2% of its total tenancy exposure. In 2008, HBOS had a favourable view of these exposures, stating that *'The quality of rental income in the investment portfolio is reflected in an analysis of the top tenants by rental income, which includes such names as… and several major healthcare operators'*. Nevertheless, three of the healthcare operators subsequently underwent financial restructuring, due in part to the highly geared nature of their operations.

Loan to value and adequacy of security

341. Corporate's problems were exacerbated by the fact that security taken on its commercial property lending proved inadequate when the market weakened.

342. Following a re-indexation exercise(61) in early 2008, the weighted average LTV of the division's property investment portfolio was 77%.(62) However, 50% of the portfolio had a LTV greater than 80%, 36% greater than 90% and 14% (or £2.4 billion) greater than 100%.

343. By the end of 2008, the IPD index had fallen 24% since March 2008 and by 36% from its high in 2007. This implies that a significant percentage of the HBOS property investment book no longer had adequate security against which to recover the loan in the event the borrower got into difficulties. HBOS, therefore, faced significant impairment losses.

344. The risk was increased by failures to perfect the security arrangements. In a meeting with the FSA it was reported that following a sample check of security 52% had issues. Similarly, the Bank of England, when reviewing a pool of property loans put forward as collateral, noted that HBOS had not registered its security interest on the property for a third of the loans. However, risks to the adequacy of security had been known: the CCRC recorded that valuation clauses were often negotiated out of contracts, or that clients would only accept a valuation every seven years, and that in practice it was difficult to get valuations. In February 2007, it had been discovered that almost 20% of valuations recorded in the division's systems were unattributed and therefore could not be relied upon. In effect HBOS had no or very weak security against a significant proportion of commercial property loans and was aware its security cover was potentially ineffective.

Growth at the height of the market

345. In the early part of the Review Period, Corporate's property growth slowed and its overall market share declined. This trend was reversed in late 2006 and, in 2007, as the market reached its peak, the division grew faster than the market as a whole.

346. Overall, HBOS grew its property exposures by 31% in 2007 (2006: 13%) compared to 18% reported by the De Montfort Review. The division experienced significant growth in most of its property categories. The division's lending to borrowers that invested in and managed property (property management and property investment) grew most, at just over 40%. Growth in lending to the higher risk segments of construction and property development was lower, at 35% and 28% respectively, but was still considerable. In other segments, lending to hotels and restaurants grew by 25% and by 19% to Housing Associations.

(61) An exercise whereby the value of the property providing security for the loan is revalued by reference to the movement in an index (e.g. the IPD index).
(62) Exposures covered by the property investment model.

347. This growth was not pursued in a strong control environment (see Part 3, Section 3.5.2). In particular, a significant part of the loan growth to construction companies, hotels and restaurants was undertaken by the JV business unit. This business unit grew exceptionally in 2006 and 2007: about 60% of new transactions for the period 1999 to 2008 were in these two years and outstanding loan balances grew by £10 billion (a doubling of the portfolio). In a period of significant organisational change, the rapid growth was not matched by a commensurate growth in resource and capability. Further, significant failings in credit risk assessment and management were prevalent (e.g. inaccurate and incomplete credit submissions; non-adherence to credit-sanctioning decisions; incomplete due diligence). The division's Risk Assurance function reviewed the JV business unit in 2008 and suggested '*senior management should consider whether disciplinary action is appropriate in certain instances given the materiality of some of the control failings*'.

348. Despite the market having turned in 2007, it appears that HBOS still had appetite to grow into 2008. There is no evidence of any significant restraint being placed on lending in late 2007, and a review of the HBOS Real Estate Portfolio in May 2008 noted that limits for further property lending were in the process of being approved by Corporate and Group Risk. Eventually growth was slowed, but ultimately the property portfolio expanded by 6% in 2008.

349. The dangers of HBOS lending into the property market late in the cycle were raised by certain external commentators (Section 2.10) but these concerns failed to resonate with the firm, which expressed disappointment that the market did not understand its business model.

350. In summary, Corporate undertook significant commercial property lending at the height of the market, immediately prior to 2008. During this period the lending can be characterised as declining margins for increasing risk – rising LTVs, poor security and pressure on covenants. HBOS was thus more exposed than most when the crisis emerged. A number of large loans and investments made to companies during this period subsequently experienced difficulties, leading to debt restructuring and impairment losses.

2.4.6 Investment in capital instruments

351. The Corporate division made significant investments in capital instruments. Capital instruments comprise equity stakes, subordinated debt finance and other forms of mezzanine finance. These assets are high risk because, as capital, they bear losses before other creditors in the event of borrower difficulties; valuations can be uncertain; and the secondary market can be highly illiquid.

352. The division initially measured the size of its exposures to capital instruments using the accounting and regulatory definitions, while also excluding undrawn commitments (e.g. it did not include certain subordinated debt instruments). Using the accounting definition, the division's investments increased from £2.3 billion at the start of 2006 to around £4.3 billion at the end of 2008. In aggregate, this represented just 3% of the division's total asset base between 2005 and 2008, and less than 1% of HBOS's total assets.

353. In 2008, HBOS started to define a risk appetite for 'risk capital' (its term for capital investments). Risk capital was defined to include equity, preference shares, loan stock and junior mezzanine financing.[63] This appears to have been a wider definition than that used by the firm for its accounting.

354. In March 2008 the division reported a £9 billion[64] exposure to capital instruments (Table 2.9). This represented about 41% of the HBOS Group's shareholder funds, and so was a significant commitment of the Group's own capital resources.

(63) However the limits did not consider the potential for equity stakes to be taken as part of a debt restructure.
(64) Of which about £6 billion was drawn.

2

355. A significant proportion of the exposure was to property and construction companies (35%)(65), with 38% to private equity funds. Many of the investments were also made late in the economic cycle.

356. In addition to the inherently high-risk nature of the capital instruments, other features of HBOS's approach increased the risk:

- the division sought to be an integrated lender, providing debt and equity, primarily in the ISAF and JV business units. This was a strategy of some pride to the organisation, and was perceived as a '*unique competitive advantage, with no direct competitors with the same approach*'. At end-September 2008, the firm held equity stakes in 20 of its top 30 largest lending exposures. As a consequence, the division increased the concentration of its exposures and created potential conflicts of interest between the equity, mezzanine and debt pieces(66); and

- a number of the exposures were connected, increasing the potential risk. For example ISAF would invest in both the private equity capital raising and then again in the underlying assets alongside the private equity house. Further, in March 2007 HBOS and West Coast Capital(67) each invested £50 million of equity in a joint venture to take Crest Nicholson private, while HBOS also provided over £1 billion in debt facilities, spread across senior, mezzanine and junior tranches in the highly leveraged deal. At around the same time HBOS had provided hundreds of millions of pounds in funding to West Coast Capital.(68)

Table 2.9: Analysis of Corporate Division's capital investments as at 31 March 2008(a)

£ billion	Committed exposures			Of which drawn exposure
	Equity and other equity(b)	Loan stock, junior mezzanine and preference shares	Total	
ISAF	4.0	1.3	**5.3**	3.6
JVs	1.5	1.9	**3.4**	2.2
SIF	0.2	0.2	**0.4**	0.3
Total	**5.7**	**3.4**	**9.1**	**6.1**
Of which drawn	3.2	2.9	**6.1**	

(a) Source: HBOS Risk Capital Appetite Statement.
(b) Loan stock and preference shares that are treated as equity (£0.2 billion against ISAF).

2.4.7 Leveraged transactions

357. The Corporate Division had £20 billion of leveraged loans outstanding in 2008 (around 16% of the loan portfolio) with a commitment to lend a further £6 billion. The majority of this had been lent since 2006, and in particular a significant amount had been entered into at the height of the market in 2007, when ISAF and JV expanded their loans by almost 70% or £12 billion. This increased the vulnerability of the division to the downturn.

358. Leveraged loan transactions involve a company taking on a large amount of debt relative to its equity capital, and are inherently risky for both the equity and debt providers. In the event of a decline in income, there is a greater likelihood that cash flows will be insufficient to pay debt servicing costs, with the consequential impact that the equity base could be eroded; and ultimately that there will be insufficient resources to repay the debt providers. To compensate for the risk leveraged exposures should provide a higher return to investors.

(65) Of which 35% is attributable to property, house builders and hotels.
(66) The firm was looking to improve the management of conflicts of interest in 2008.
(67) A private investment firm in which Sir Tom Hunter was a founding partner.
(68) Crest Nicholson subsequently swapped £630 million of its debt for equity in a corporate restructuring to reduce the debt burden of the group. In 2009 £227 million, £50 million, £49 million was written off in respect of loan stock, mezzanine debt and senior debt, while a further £38 million of senior debt was written off in 2011.

359. Leverage had been increasing in the leveraged buy-out (LBO) market for a number of years prior to 2007 and had reached the point where the FSA regarded leverage as 'excessive' and posing a risk to lenders.(69) For example, multiples of debt to earnings before interest, taxes, depreciation and amortisation (EBITDA) of between 3.5 and 5.7 had become commonplace in the market in 2006; and at the top of the market in 2007, multiples of 7.0 were not unusual.

360. In early 2008, an FSA survey collected data from a range of banks, enabling the Review to compare HBOS to others. Each bank in the survey provided their total LBO activity and their five largest deals for the first and second halves of 2007. Generally the survey found risk to have significantly increased when measured by leverage and interest cover. In respect of HBOS the survey found:

- HBOS to have been the market leader in new deals in the second half of 2007, after the market had effectively turned, advancing US$15 billion.(70) A total of US$25 billion was lent across the whole of 2007;
- after hedging, sell-downs and redemptions HBOS had the second largest amount (around US$18 billion) of LBOs outstanding at the end of 2007, with a further US$3 billion worth of deals in the pipeline;
- however, HBOS had reduced the average leverage on its new deals. This fell from 5.7 in the first six months of 2007 to 5.2 for the second six months. Compared to the other firms in the survey these multiples were some of the lowest, with the average for the survey around 6.6; and
- similarly, interest cover showed HBOS (2.4) as having a marginally better risk profile than the survey average (2.1) for the last six months of 2007.

361. However, the survey found that HBOS had taken on relatively more risk in terms of leverage and interest cover in respect of its largest and most recent deals. HBOS's top five deals in the last six months of 2007 totalled US$5.1 billion (debt exposure), with the largest being US$1.7 billon:

- these had an average leverage of 9, compared to an average of 7.4 for the top five deals of all firms in the survey and 6.7 for all firms' deals. The highest HBOS leveraged deal at the point of the survey was 13 while the lowest was 7 (though at the point of sanctioning, one deal had a leverage of 17);
- the interest cover on the top five deals was 1.6, below the peer group average of 1.9 and below the HBOS total of 2.4 for all deals; and
- HBOS's equity stakes in these deals was US$2.0 billion and ranged from 14% to 36% of the total debt plus equity exposure. The highest leveraged deal had the smallest equity component. However, it was not the case with the other deals that high leverage meant proportionally smaller equity stakes. So two deals that each had leverage of 10 were accompanied by equity stakes equal to 34% and 36% of the total exposure, whereas equity represented 20% of a deal with leverage of 8.

362. Of the top five deals, three subsequently had to be restructured due to financial difficulties.

363. In the first three months of 2008 HBOS remained active, launching deals worth €4.3 billion in total, which made it the fourth most active bank by number, but the second by average deal size.

(69) FSA *Discussion Paper: Private Equity 06/06* and the *Bank of England Financial Stability Report*, April 2007.
(70) The FSA survey was in US$.

364. Overall, therefore, HBOS was not an outlier among the major UK banks in pursuing highly-leveraged transactions. Nevertheless, by entering into a significant number of transactions at the height of the market, it was left vulnerable to the sudden downturn in the market.

2.4.8 Stress testing/scenario analysis

365. Stress and scenario testing is a key tool to test the risk of exposures, and therefore to inform management on whether the business being written is within its risk appetite. Both the firm and the FSA initiated stress testing in the Review Period.

366. However, the outcomes of the various stress tests conducted by the firm were generally benign or the underlying scenarios were not particularly severe. As a result, they did not serve as an adequate warning of the risk building up in the portfolio.

Firm's own stress tests – annual planning

367. As part of the Group's annual planning cycle, the division undertook a number of stress tests in the form of scenario analysis and sensitivity testing.(71)

368. Although the stress tests were a component of the business plans that were reviewed and signed off by senior management, it appears they generally lacked prominence. This was recognised by the Group, and in 2007 there was a change in the annual planning process whereby stress tests were undertaken separately to the main planning process; the aim being that stress testing received sufficient attention and greater individual focus, and was not lost in the central scenario planning processes.

369. The scenario analysis included both an upside and downside stress over three years, described as plausible but unlikely.(72) The outcomes of the annual stress tests suggested that the division would not incur significant losses in the event of a downturn, and at no time would the division's profitability be seriously threatened (Table 2.10). In early 2008, following the FSA request for a revised scenario, the division projected a 47% reduction in profits.

Table 2.10: Analysis of Corporate Division's projected underlying profitability for the first three years for each of the annual business plans prepared 2005 to 2007[(a)]

£ billion	Group business plan prepared		
	2005	2006	2007
Central scenario: three-year profitability	4.9	6.8	8.3
Adjustment for downside stress scenario	(1.5)	(0.8)	(1.7)
Downside stress scenario: three-year profitability	3.4	6.0	6.6
Percentage reduction in underlying profitability	-31%	-12%	-21%

(a) Source: HBOS Group business plans.

370. The sensitivity tests included a one-year credit stress until 2007, when it was dropped from the Group business plan. This stress was based on the early 1990s recession, although the firm reduced the impact of the recession by a third for what it regarded as fundamental changes in the market and lending practices. The impact of the analysis was to reduce Corporate's profits by around £1.5 billion in 2005 and 2006. Without the firm's downward adjustment the impact would have been around £2.2 billion per annum.

(71) The stress testing typically included an upside as well as one or two downside scenarios.
(72) By 2007 the stresses were being aligned with the Basel II process, although as described in Part 4, Section 4.6.3, Box 4.8, the FSA did not regard them as sufficiently severe.

371. The outcome of the division's stress testing appears to have provided a high degree of confidence that it was resilient. However, a key feature of Corporate's stress testing was judgement. The stress testing process involved engagement with senior management and individuals in Credit Risk, the business and finance to provide 'expert opinion and judgment'. The analysis was further discussed by the Corporate Board, and a challenge session held to agree the numbers. The involvement of the business to provide expert opinion had the benefit of making full use of the division's resources, but it ran the risk of introducing an optimistic bias into the results, as these were the very people who originated the deals and so lacked independence.

372. As set out elsewhere in this Report, it seems that there was a significant degree of optimism and, consistent with that, the Review considers the firm was bounded by its experiences, leading to a failure to comprehend the potential severity of a stress, and in particular how events or actions influence other events or actions (e.g. that the withdrawal of a significant lender from a market would reduce liquidity in that market with a consequential detrimental impact on prices).

373. The potential optimism is also illustrated by the firm's stress testing in 2007 and contrasting the impact of a stress on Corporate's impairment losses with the Retail Division. In the stress scenario Corporate's impairment losses increased by 31% from its central scenario. For the same stress and central scenarios, Retail, which made greater use of models, projected its impairment losses to increase by 119%. No challenge appears to have been raised concerning this difference.

374. The potential optimism extended to the division's proposed management actions in the event of a stress. These included cutting back on lending, in particular high risk lending. However, in practice, as the crisis developed in 2007 and 2008, the division was slow to reduce lending. These actions did not prove effective both because the firm was unable to exercise control over its lending in a timely fashion and because it feared damage to its reputation. This suggests that it had not considered properly the feasibility of management actions within its stress testing.

FSA requested stress tests

375. In January 2005, the FSA asked the division to undertake a number of stress tests, specifically to test the resilience of its exposures to commercial property, but also to test the overall resilience of the division. The FSA's concerns were that HBOS, along with RBS, dominated the UK commercial property market, and so in the event of a downturn, would have little option but to hold on to exposures (i.e. they could not be sold to or refinanced with other banks) and retain the risk of default.

376. These stress tests covered a range of scenarios and severities, including the failure of HBOS due to commercial property losses (termed catastrophic) and a three-year recession more severe than the 1990 to 1991 recession.

377. The firm commissioned external consultants to provide a view on the likely probability of the various scenarios. Their view was that the catastrophic scenario had a probability of less than one in 100,000 and would be more likely to be derived from an operational failure or external event (e.g. earthquake, terrorist attack) than any economic scenario; that wiping out HBOS's profits for three years had a one in 5,000 years likelihood; and that a three year recession had a likely probability of one in 350 years.

378. The firm in its overall conclusion to the exercise noted that where the probability of a scenario was too small to estimate accurately, it was not planning to take action (i.e. as for the catastrophic and three years of losses scenarios), and that for the three-year recession and its own stress testing it would take actions along the lines of those taken in the early 1990s (for example, creating a multidisciplinary team to manage distressed assets) in the event of the scenario emerging. The firm also noted that an early 1990s scenario would bring opportunities

as well as risks. When the crisis came continued lending by division exacerbated HBOS's funding difficulties and, as set out in Section 2.11, the multidisciplinary team that managed distressed assets failed to cope.

379. Finally, the firm noted that it took from the exercise: '*some comfort on the robustness of the overall portfolio and our ability to withstand a downturn without materially impacting on the profitability of HBOS or threatening its survival*'.

380. It seems reasonable that the probability of some of the scenarios was very small. However, it appears that this was not correct for all of the scenarios. It was claimed that the loss rates associated with the three years of losses scenario were unprecedented based on historic loss rates. The cumulative insolvency rate in the stress test was 6.9%, which compares very closely to the three year insolvency rate in the early 1990s of about 6%. To assign this only a one in 5,000 probability was insufficiently conservative.

381. Further detail on the FSA required stress tests can be found in Part 4, Section 4.4.3, '*Supervision of asset quality in Corporate*'.

Stressing the HBOS portfolio

382. Given its risk distribution, it was reasonably foreseeable by HBOS that, in the event of a significant downturn, the Group's corporate portfolio would experience a high level of impairments.

383. As an illustrative exercise, using the credit ratings as of December 2006, S&P default rates from 1989-1993, assuming a loss given default of 45% but without adjusting for potential management actions, the Review generated potential losses under a five-year stress period of between £9 billion and £12 billion for the corporate portfolio. Using 2008-2012 default data, the figures were lower, between £5 billion and £8 billion, but still considerably higher than HBOS appeared to consider possible. While these results are only indicative, given the high-level assumptions used, they suggest that HBOS should have been able to anticipate the potential for significantly greater losses in a challenging economic environment. It should also be noted that the losses that HBOS experienced were greater than this, suggesting the other issues highlighted in this section also played a role.

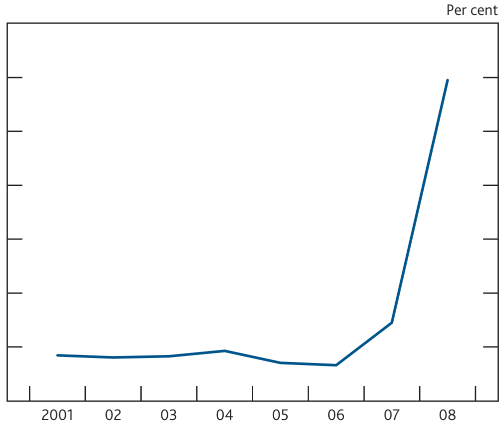
384. Another approach to stress testing the corporate portfolio that HBOS could have used would have been to apply the loss rates that were experienced during the recession of the 1990s. On a cumulative basis, impairment losses for the period 1991 to 1995 were around 15% for property and construction and 7.5% for other corporate exposures. This suggests a potential loss of around £10 billion over five years for the HBOS portfolio. HBOS believed, erroneously, that the market was much stronger than in the 1990s and that its book had improved, largely due to a lower proportion of speculative development. However, a more conservative approach would have suggested greater caution around this assumption.

385. In fact, the performance of the commercial property market turned out to be weaker than even the 1990s recession, as illustrated in Chart 2.11. This helps to account for the higher losses experienced.

2.4.9 Loan impairment losses in Corporate

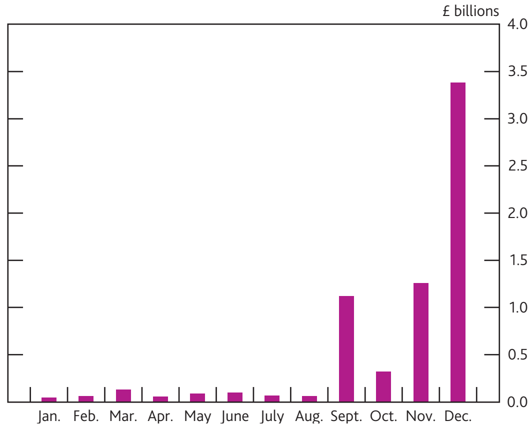
386. In the years from 2008 to 2011, the Corporate Division recognised £21.9 billion of loan impairment losses, equal to 18% of its outstanding loan balance at the end of 2008, sufficient to cause the failure of the firm absent further capital injection.

Chart 2.37: Impaired loans as a percentage of year end loans and advances[(a)]



(a) Source: *Annual Reports and Accounts*.

Chart 2.38: Monthly impairment losses charged to the income statement in 2008[(a)]



(a) Source: Corporate Division Management Accounts and 2008 *Annual Report and Accounts*.

387. Prior to the onset of the financial crisis, the annual charge for impairment losses had increased, as had the overall level of impairment provisions. However, the overall level of impaired loans as a percentage of loans and advances was relatively static, even declining a little between 2004 and 2006 (see Chart 2.37). There was no upward trend as might have been expected from the overall declining level of asset quality.

388. The prevailing accounting standard required impairments only to be made where a loss had been incurred, not for losses that might be incurred in the event of a downturn. In the period immediately preceding 2007, there had been a prolonged period of GDP growth, property (collateral) prices were rising, and company insolvencies were stable.[(73)] Under the tests used at the time there were no obvious triggers to justify an increase in the level of impairment provisions across the book as a whole. This may explain Corporate's lack of attention to the increase in the underlying risk in its book, despite the signs that the market was reaching its peak. This points to the weakness of the accounting standard in not recognising the potential for future impairments or expected losses (see Appendix 4, PCBS question 1 for more detail on accounting impairments).

389. A feature of the division's management information prior to 2008 was that asset quality was reported as being good, and this was in part justified by reference to the low level of impairment provisions.

390. Following the onset of the crisis, the division's impaired loans almost doubled to £3.2 billion at the end of 2007.[(74)] However, impairment provisions only marginally increased, from £0.7 billion to £0.8 billion. Of the total impaired asset figure of £3.2 billion, half had no provision. A footnote to the financial statements explained these loans '*… have been individually assessed as having impairment characteristics but where we expect, after taking into consideration collateral and other credit enhancements, full recovery of both interest and capital*'. Internally it was explained the increase was '*mainly due to the recategorisation of High Risk and Good book exposures …using 90 days past due as a measure*' to align with the Basel II default definition.

391. Throughout the early part of 2008, impairment losses did not show any substantive upward trend. This changed dramatically in September as losses started to be recognised, eventually totalling almost £7 billion for the year (Chart 2.38). The failure of Lehman Brothers and the events of September 2008 led to a significant deterioration in the economic conditions.

(73) The Insolvency Services: Company liquidations in England, Wales and Scotland.
(74) On a comparable basis (e.g. adjusted for the transfer of the European business in 2007).

2

However as described in Section 2.11, the Group's auditors consistently expressed concern in 2008 that the division's provisions were at the least prudent end of the accounting range and there was a slowness in provisioning.

392. The impairment losses for the period 2008 to 2011 are shown in Table 2.11. These losses equated to 18% of the drawn loan balance as at 31 December 2008. Around 31% of the losses were incurred in 2008 as the financial crisis started to affect the economy more generally, although the largest share (51%) of the losses was incurred in 2009 as the downturn took hold. Continued weakness in the economy resulted in further losses being reported in 2010 and 2011.

393. The majority of the losses (£15.7 billion or 72%) were incurred in respect of the division's exposures to construction, property and the related sectors (i.e. hotels and restaurants), and equated to approximately 24% of the division's outstanding loans to these sectors as at the end of 2008.

Table 2.11: Sectoral analysis of the Corporate Division's loan impairment losses[(a),(b)]

£ billion	2008 gross balance[(c)]	Annual impairment loss				Cumulative	Loss as a percentage of 2008 balance
		2008	2009	2010	2011		
Construction and property	52.9	2.8	6.6	1.8	1.4	12.6	24%
Other business services	15.7	0.6	1.6	0.9	0.1	3.2	20%
Hotels, restaurants and wholesale and retail trade	13.3	1.0	1.5	0.5	0.1	3.1	23%
Financial intermediation	16.6	0.4	0.5	0.1	0.1	1.1	7%
Manufacturing industry	6.2	0.3	0.4	0.1	0.1	0.9	15%
Other	18.3	1.6	0.5	(0.2)	(0.9)	1.0	5%
Total	**123.0**	**6.7**	**11.1**	**3.2**	**0.9**	**21.9**	**18%**
Distribution of losses by year		31%	51%	15%	4%	100%	

(a) Source: HBOS regulatory reports to the FSA and Review calculations.
(b) For the reasons set out in footnote (b) to Table 2.4, the Review has, in part, used judgment to allocate losses to the business segments.
(c) The gross balance is before deduction of impairment provisions.

394. Towards the end of 2008, HBOS recognised that it might be more exposed than some other banks due to the nature of its business model: '…*we expect Corporate's performance to be significantly worse than our main competitors. This is driven by our high exposure to real estate particularly house building, holdings of risk capital …and certain concentrations in troubled single names across the Division.*'; and in respect of the JV business: '*This business is exposed to… significant exposures to property development…*'[(75)]; and '…*due to the positioning of the HBOS book at a more 'exposed' section of the risk spectrum, as well as concentrations in sections that were under particular pressure*'.[(76)]

395. KPMG expressed similar views to the Group Audit Committee in February 2009, in particular noting HBOS's appetite to run single exposure concentrations well in excess of the other UK clearers (Section 2.11.4).

396. The Annual Reports and Accounts for HBOS and LBG both gave reasons for the high level of losses. In general they highlighted the same risk factors:

(75) Papers to the Group Audit Committee and Board in October 2008.
(76) HBOS Group Board minutes, 11 December 2008.

- The HBOS 2008 *Annual Report and Accounts* stated that: *'The level of impairment losses experienced, especially in the last quarter, was principally a reflection of the acceleration in the deterioration in the economy and as a result of applying a provisioning methodology more consistent with that used by Lloyds TSB. The shape of the Corporate book, and in particular its exposure to house builders, risk capital (loan stock, preference shares and ordinary shares) and large single credit exposures, exacerbated the impact'*.

- The LBG 2009 *Annual Report and Accounts* stated that: '*The significant increase in impairments in 2009 was against the backdrop of weaker economic conditions; application of Lloyds Banking Group prudent valuation assumptions; portfolio concentration in property lending; material single name exposures; poorly structured lending agreements; and aggressive loan-to-value positions at origination in the legacy HBOS portfolios.*'

397. The depth and length of the recession starting in 2007 undoubtedly contributed to a number of companies experiencing financial difficulties and going into administration. It was the policies and actions that the Corporate Division pursued in the benign times prior to the crisis that determined the extent to which it was exposed to the downturn and how resilient it was. In this regard, the Review finds that the policies and actions of the firm created a business model that was highly cyclical and vulnerable to the effects of the recession on its performance. In particular, the Review concludes that:

- the firm had a high risk strategy from: developing a large commercial property portfolio including a very significant construction component; making highly leveraged loans; an approach in which assets were originated prior to seeking to distribute and taking equity and mezzanine stakes in the same companies to which it was lending. This was compounded by actively conducting sub-investment grade lending and supporting individual borrowers;

- notwithstanding the division's pursuit of high-risk business, it did not understand and/or did not have regard to the risks it had accepted. It severely underestimated the risks within commercial property, considering it a safer form of lending; it failed to recognise the risks inherent in its business model; its through the cycle lending philosophy led to complacency about the risks of a downturn, instead seeing an opportunity for gain; it failed to recognise until too late that its business model had changed since the 1990s and was untested in a downturn; and it failed to recognise or act on the emerging risks sufficiently quickly. This led to excessive growth very late in the cycle. The overall risk in the portfolio was, therefore, considerably higher than the division thought; and

- poor systems and controls exacerbated the risks. Generally they did not keep track with the growth in assets and increasing complexity of the business; the division lent outside its risk appetite; a number of deals were weakly structured (i.e. low margins and complex tiering of lending) with poor security; the assessment of credit risk was substandard; and the division was not adequately resourced to manage the problem loans as they started to emerge.

398. A significant number of HBOS's loans have been restructured, with debt being written off in exchange for an equity stake. This is a normal debt recovery action by banks as they hope to realise some future value on the equity stakes and recoup some of their loss. However, to receive the benefit of any future value depends upon the bank being able to hold the equity through the downturn of the economic cycle. HBOS failed in the financial crisis: it did not prove to be a through-the-cycle lender.

399. The growth of the Corporate Division, both in absolute size and in relation to the rest of the Group, combined with the high-risk features of its business model meant that the size of the losses would have been too great for HBOS to withstand if it had not been rescued.

2

2.5 Asset quality – International Division

2.5.1 Introduction

400. The purpose of this section is to consider the nature and quality of the assets and business of HBOS's International Division. The chapter is structured as follows:

- Section 2.5.2 examines the divisional strategy through the Review Period;
- Section 2.5.3 examines the performance of the division, including an analysis of the division's growth plans; its commercial property exposures, and its large exposures; and
- Section 2.5.4 examines the division's eventual losses from its Irish and Australian businesses.

2.5.2 Divisional strategy

Divisional structure

401. At the beginning of the Review Period, the International Division consisted of businesses in Australia (HBOS Australia, (HBOSA)) and Ireland (Bank of Scotland (Ireland) Ltd (BOSI)). In October 2005, it was expanded to include Europe and North American (ENA) components – an amalgamation of all of HBOS's banking and insurance operations in these territories.

402. HBOSA was made up of BankWest (a retail and commercial bank based in Western Australia), corporate lending and asset finance businesses (Bank of Scotland International Australia Limited and Capital Finance Australia Limited) as well as insurance and investment businesses (St Andrews and RACV). These businesses were inherited by HBOS from BoS, which had generally acquired them in the mid-1990s.

403. BOSI emerged from the purchase and subsequent merging of two local banks: Equity Bank in 1999 and the larger ICC Bank in 2001, which was bought from the Irish government. Both these banks had operated in Ireland for a number of years, in particular ICC Bank, focusing on commercial and industrial lending. ICC Bank had developed concentrations to hotels, venture capital, SMEs and pubs, restaurants and commercial property, in line with its founding objectives. BOSI later took on Halifax's Irish mortgage portfolio and, from 2004, pursued the development of a full scope retail bank with a branch network and offering customer accounts.

404. ENA was made up of a large number of smaller, geographically and sectorally diverse businesses, with little commonality apart from their non-UK jurisdiction. ENA included an American lending operation which focused on the gambling, oil and gas and real estate sectors; a mortgage operation in Spain; and Clerical Medical Europe, an insurance business; as well as operations in Netherlands, France, Germany and Canada.

Divisional philosophy, risk appetite and objectives

405. As set out in Section 2.3.3 and Part 3, Section 3.5.3, '*Management and governance failings in relation to International Division*', the main aim of the international businesses within the Group was to provide diversification away from the Group's historic concentration in the United Kingdom. Another objective of the international operations was to gather deposits to relieve pressure on HBOS's funding plans.

406. The FSA's minutes of a meeting with the firm in 2005 record that: '*he* [Mr Crosby] *would not have looked to enter the Australian market. However, having acquired the BankWest shareholding via Bank of Scotland, he had to make the best of the situation. They* [HBOS] *had concluded the best strategy was to gain full ownership and make the assets perform. In doing this the business also became more attractive to an incumbent*'. This provides useful context to the approach of HBOS to its international operations.

407. In both Australia and Ireland, HBOS sought to position itself as a new entrant in the retail banking market, set on changing the traditional competitive landscape and providing more attractive products for customers than local operators. In both countries the aim was to rapidly expand retail and corporate businesses, in the process becoming a full scope bank and, within three to five years, becoming the third or fourth largest bank in that country. Senior management advised the FSA that this strategy was a repeat of their expansion experience in the United Kingdom following the 2001 merger, and that they would therefore leverage upon those experiences.

408. While both countries had a small number of incumbent banks, the Australian banking system was more formalised and rigorous in its controls, relying less than the Irish banking market on informal connections between banks, borrowers and professional advisers such as accountants, solicitors and surveyors.

409. The strong growth strategy also included rapid physical growth of the HBOS presence in these countries. In Ireland, BOSI bought a network of electricity showrooms from the Irish Electricity Supply Board (ESB) and began transforming them into bank branches at a rate of three per month for fourteen months from the beginning of 2006. BOSI also gained around 150 (non-banking) staff and a small finance loan book in the deal. At the time, this was presented as an innovative cost effective solution to rapidly achieve a substantial footprint upon which to pursue aggressive growth in market share. A branch network would also enable the existing reliance on broker channels to be reduced.

410. This seems to have been a high-risk strategy and it is questionable whether the risks were properly thought through. BOSI had an existing staff resourcing issue, aside from recruiting new staff and training the ex ESB staff, all at a time of planned rapid growth and expansion into new products. At the same time the infrastructure, governance and risk management frameworks would need building out to accommodate the planned growth. Finally, BOSI would not initially be in a position to offer current accounts, and so would lack a potential early warning indicator of troubles with its customers. In hindsight, this was a blueprint for rapid uncontrolled growth with inadequate risk mitigation.

411. In Australia, HBOSA set out to expand the BankWest network rapidly into eastern Australia through a network of new branches and business banking centres. In the Group Business Plan 2007 – 2011, HBOSA described its objective of opening 160 retail branches and 21 business centres as key to a five to seven year strategy of increasing market share from 3% to 8%. This was considered a viable aim by HBOSA at the time given the levels of customer dissatisfaction with the incumbent banks.

412. In ENA, strategic coherence was a significant challenge as the division constituted many small businesses at different stages of development: the Group Business Plan 2006 – 2010, said that '*development of a coherent strategy and appropriate support infrastructure for our Europe & North America division is a key priority*'. The focus was also regularly on whether to acquire more businesses or sell existing ones.

413. ENA also differed from HBOSA and BOSI in that its strategy was a less direct copy of the UK business model. While ENA established a branch network in Spain (Banco Halifax Hispania), which serviced UK and Irish citizens based in Spain, elsewhere it sought niches to exploit, rather than aiming directly at breaking up established, oligopolistic markets. However, these niches were often property-based, such as financing the building of a casino in the United States, or online mortgages in the Netherlands, thus providing geographic but not sectoral diversification.

414. ENA also experienced significant overlap with the Corporate Division in its client base, as many Corporate clients also had interests in Europe and North America. The European corporate business of ENA was eventually transferred back to Corporate in 2007.

415. While the very diverse components of the International Division appeared to have been '*cobbled together*', there were some clear parameters within which the division worked in deciding areas for expansion:

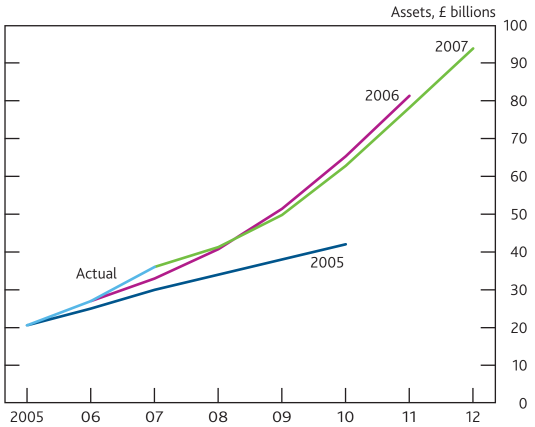
- the Group chose jurisdictions based on cultural similarities with the United Kingdom, preferring mature rather than emerging markets, similar regulatory regimes and the fact that potential customers spoke English. As a result, HBOS initially discounted Asia and South America as suitable markets for growth, though there is evidence that as the markets most familiar to HBOS turned, the firm began to consider markets such as China;

- like the wider Group, the division generally grew organically, citing lower costs. In hindsight, this was a false economy given the risks (e.g. adverse selection) from entering markets at a late stage in the cycle while seeking rapid growth, as was the case for HBOS within both Australia and Ireland; and

- HBOS's UK businesses did not operate within the subprime market. The division's desire to be consistent with the Group led to the eventual sale of Drive, a subprime vehicle leasing business in the United States.

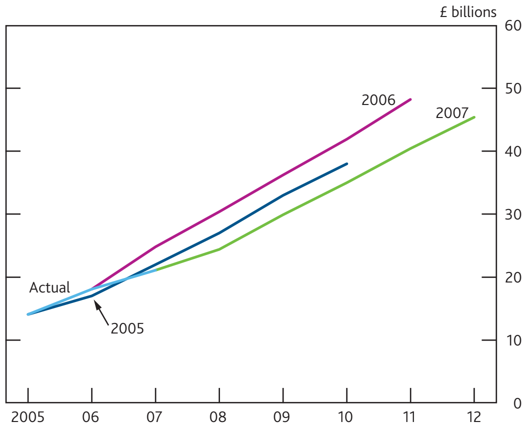
416. However, despite the presence of these parameters the international businesses were not a coherent unified component of the HBOS Group.

Chart 2.39: Asset growth targets for HBOSA the Group business plans[(a)]



(a) Source: HBOS Group business plans and *Annual Reports and Accounts*.

Chart 2.40: Asset growth targets for BOSI in the Group business plans[(a)]



(a) Source: HBOS Group Business plans and *Annual Reports and Accounts*.

Asset growth targets

417. Forecasts for asset growth were significant in each of the business plans in the Review Period, as the division sought to rapidly seize market share. While annual GDP growth in either Ireland or Australia never rose, nor was expected to rise, above 6%, asset growth of up to 32% per year was targeted by HBOS in successive business plans. Growth was from a low base (so higher percentages reflected that position) but this was nonetheless an ambitious strategy. Chart 2.39, Chart 2.40 and Chart 2.41 also show that the International Division's asset growth rate aspirations were not tempered in late November 2007 when the global economy began to turn (with planned asset growth in the Group business plan prepared in 2007, similar to the plan prepared in 2006 and higher than the plan prepared in 2005). The overall level of planned assets for ENA had declined, but this was due to the sale of Drive and the transfer of European lending to the Corporate Division.

418. Despite significant growth targets, HBOS Group did not set out risk appetite statements for any of the international businesses at a group or divisional level beyond sectoral concentration limits, and a general aim to recreate the business model that HBOS had adopted in the United Kingdom.

2.5.3 Performance

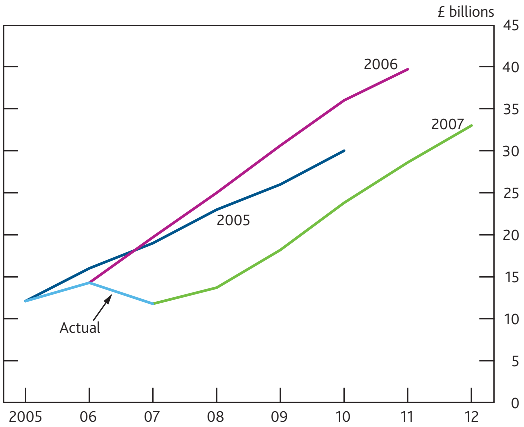
419. The International Division was consistently the smallest component of a rapidly growing Group book. So, while International's assets almost doubled[(77)] between 2004 and 2008 to £68 billion (an annualised growth rate greater than any other division of the Group), in 2008 it only accounted for 10% of total Group assets.

420. Asset growth in the International Division was primarily due to an increase in lending to customers in the construction and property and residential mortgage sectors. In 2004 lending in these areas was £16 billion or 40% of all loans. This had increased to £45 billion or 67% of the division's loans by the end of 2007.

(77) After allowing for the transfer of about £4 billion of assets to the Corporate Division in 2007.

2

Chart 2.41: Asset growth targets for ENA in the Group business plans[(a)]



(a) Source: HBOS Group Business plans and *Annual Reports and Accounts*.

421. Of the total International business, the largest volumes were in Australia where net lending grew 127% from £14.6 billion in 2004 to £33.2 billion in 2007 mainly in the corporate and residential mortgage sectors through the broker channel. In late 2008, as the Group looked to reduce funding pressures on its balance sheet, BankWest, with £27 billion of loans, was sold at a loss to Commonwealth Bank of Australia, more than halving the size of the Australian business (Table 2.13). Despite trying to also sell the other parts of the Australian business (mainly corporate and commercial property lending) the Group was not able to do so.

422. The growth rates in Australia significantly outstripped the other major Australian players in each of the years 2005 to 2007, as the division looked to rapidly grow its balance sheet and gain market share. This was almost four times the average of the big five Australian banks in 2005, and still almost twice the average in 2007. It is recognised however that HBOSA's balance sheet was considerably smaller than the other banks which meant that overall its assets generally increased by a smaller amount in absolute terms than others.

423. The other high growth area was Ireland, where International grew by 146% from £8.9 billion in 2004 to £21.9 billion in 2007 and, by FSA estimates, HBOS had achieved its goal of being the fourth largest player by 2008. Growth continued through 2008, 10% in local currency terms (although much higher on a sterling basis as it depreciated over 30% against the euro).

424. In 2005, growth in new business volumes in 'Irish business banking' was broadly in line with the Irish market. But by 2007 it was outstripping the Irish market. Market share in retail increased in both 2006 and 2007. A fall in fees behind plan and some slowing of activity in 2006 had led to a '*… concerted effort to reinvigorate sales*' and loan growth for 2007, the peak of the market, exceeded that achieved in 2006.

425. The size of ENA's balance sheet grew but it was more varied throughout the period due to the sale of the Drive business in 2006 and the transfer of European lending to Corporate in 2007. As with Ireland, its growth in 2008 was affected by the depreciation of Sterling.

426. The International expansion strategy was characterised not only by rapid growth, but also by movement into riskier areas, as the division sought to innovate and import structures and strategies which had appeared successful in the United Kingdom. From around 2006, both Australia and Ireland looked to develop the joint venture and integrated finance packages that Corporate provided in the United Kingdom. Another innovation was securitisation; in 2007 BOSI began packaging client property portfolios for onward securitisation, when the Irish

2

securitisation market was at a very early stage of development. The division also looked to increase the size of deals in support of chosen businessmen on the basis of the standing of the individual as well as the dynamics of the particular deal.

427. As a result of this aggressive strategy, underlying profits for the division as a whole grew until 2007, after which they fell dramatically in 2008 as impairments started to increase. Net interest income grew strongly during the period, but as net interest margins declined this was due to increased lending.

428. In contrast, the division failed in its aim to increase deposits. As noted in a July 2008 Board paper: *'all International businesses have been asset led and, in truth, insufficient attention has been paid to self-funding ratios due to the previously plentiful supply of wholesale funding. An organisation that is already exposed to wholesale funding risk cannot afford to exacerbate such risk by pursuing an aggressive asset growth plan overseas'*.

Table 2.12: Income statement for International Division 2004-2008[(a),(b)]

£ billion	2004	2005	2006	2007	2008[(c)]
Division					
Net interest income	0.6	1.0	1.2	1.1	1.5
Non-interest income	0.6	0.5	0.9	0.8	0.4
Expenses	(0.6)	(0.7)	(1.1)	(1.0)	(0.9)
Impairment losses	(0.2)	(0.2)	(0.2)	(0.1)	(1.0)
Other[(d)]	0	0	0.2	(0.1)	(0.8)
Profit before tax	**0.4**	**0.6**	**1.0**	**0.7**	**(0.8)**
BOSI					
Net interest margin	2.01%	1.77%	1.73%	1.81%	N/A
Impairment losses as a % of average advances	0.15%	0.20%	0.20%	0.12%	N/A
Cost-income ratio	38.4%	42.7%	43.6%	42.9%	N/A
HBOSA					
Net interest margin	2.41%	2.39%	2.33%	2.15%	N/A
Impairment losses as a % of average advances	0.14%	0.19%	0.27%	0.28%	N/A
Cost-income ratio	50.6%	52.3%	47.7%	51.3%	N/A
ENA[(e)]					
Net interest margin	2.80%	4.09%	3.7%	1.47%	N/A
Impairment losses as a % of average advances	1.81%	1.26%	1.13%	0.13%	N/A
Cost-income ratio	26.6%	27.5%	28.0%	35.0%	N/A

(a) Source: HBOS *Annual Reports and Accounts*.
(b) 2004 is the comparative in the 2005 *Annual Report and Accounts* to reflect the move to IFRSs in 2005.
(c) N/A: the 2008 *Annual Report and Accounts* did not provide a breakdown between BOSI, HBOSA and ENA.
(d) Typically gains and losses on disposal of businesses: Drive in 2006 and BankWest in 2008.
(e) Part of the European business (around £4 billion of assets) was transferred to the Corporate Division in 2007.

2

Table 2.13: Summarised balance sheet for International Division 2004-2008[a]

£ billion	2004	2005	2006	2007	2008
Loans and advances to customers	32.4	42.9	53.0	67.1	61.0
Of which:					
Australia	14.6	19.7	24.5	33.2	12.8
Ireland	8.9	12.1	15.9	21.9	30.7
ENA	8.9	11.1	12.6	12.0	17.5
Impairment provisions on advances	0.3	0.3	0.3	0.3	1.1
Impairment provisions as a % of closing balances	0.83%	0.72%	0.51%	0.48%	1.79%
Impaired loans	0.5	0.5	0.6	0.8	3.1
Impaired loans as a % of closing advances	1.60%	1.28%	1.17%	1.23%	5.02%
RWAs	29.5	38.7	47.1	56.9	56.7
Customer deposits	10.0	13.9	18.3	23.6	6.6[b]

(a) Source: HBOS *Annual Reports and Accounts*.
(b) The drop in deposits is a result of the sale of BankWest to Commonwealth Bank of Australia in 2008.

Portfolio composition and concentrations

429. Commercial and corporate lending was the historical and dominant business of each area throughout the Review Period, while within the retail portfolios lending was predominantly secured on mortgages (Table 2.14).

Table 2.14: Retail and corporate loans within International[a]

£ billion	Australia			Ireland			ENA		
	2004	2007	growth	2004	2007	growth	2004	2007[b]	growth
Retail secured	5.4	13.0	139%	2.2	6.2	186%	3.8	7.7	103%
Retail unsecured	1.0	1.3	30%	0.5	1.3	145%	0.6	0.0	–
Corporate	8.2	19.0	131%	6.3	14.5	131%	4.6	8.3	81%

(a) Source: HBOS *Annual Reports and Accounts* and Review calculations.
(b) The corporate exposures have been adjusted for the transfer of corporate business to the Corporate Division in 2007.

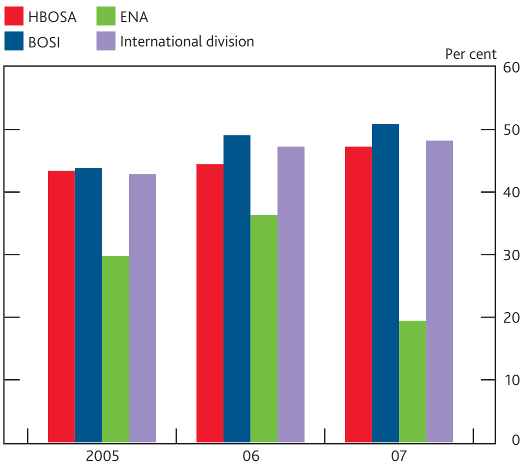
430. Growing the retail franchise was a core strategic aim, but while mortgages are traditionally less risky than commercial loans, they did not necessarily improve the Division's risk profile, as to gain market share in Australia and Ireland meant competing aggressively by offering attractive terms. So, for example, BOSI offered mortgage tracker rates between a half and one percentage point below the incumbents' typical tracker and standard variable rate offerings or high LTVs (100%) during the boom years.

BOSI secured retail

431. The Irish retail portfolio had a high proportion of interest-only mortgages (almost 50% for all mortgages and over 90% for the BTL portfolio). The risk had been recognised in June 2006, when it was also noted that it made BOSI an outlier compared to peers. In 2006 this was largely a heritage issue due to the limited product range of the Halifax Irish retail portfolio transferred to BOSI and it was considered at the time that the risk profile of this portfolio was good. Despite an expectation that the broader product range of the retail strategy would reduce BOSI's proportion of interest only products, this does not appear to have happened.

432. Even as house prices in Ireland fell by 7.3% in 2007 and were predicted to fall by a further 10% in 2008, the division only reduced its maximum home loans LTV from 95% to 90%, and its BTL LTV from 90% to 80%. The division was still concerned to maintain a competitive position: '*In order to maintain our challenger brand position we do not wish to lead the changes within the market but have followed competitor moves closely*'.

Chart 2.42: Commercial property concentrations – HBOSA, BOSI, ENA and International Division[(a),(b)]



(a) Source: HBOS *Annual Reports and Accounts* and Review calculations.
(b) Excluding exposures to hotels and restaurants.

433. In the first few months of 2008, BOSI lagged the competition in raising margins and reducing commissions to brokers. Brokers were also encouraging switching in an effort to stimulate business volumes. As a result, BOSI gained unexpected market share, with new BTL lending exceeding its product limit. By May 2008, BTL lending had ceased but the portfolio was now around €1.2 billion, over twice the level in 2006. This highlights the inherent risks of a broker-led mortgage business. Without strong controls, a lender can be exposed to the risk that brokers have conflicting objectives leading to unplanned growth and excessive risk.

Commercial property

434. Like Corporate, International was heavily exposed to commercial property. In particular, both Australia and Ireland had significant concentrations at close to 50% in their corporate books by 2007 (Chart 2.42). While ENA initially also had a large property book, the European component was transferred to Corporate in 2007, reducing the concentration to around 20%. Coupled with the mortgage portfolios, Australia and Ireland were both heavily exposed to the local property markets.

BOSI commercial property

435. By the end of the Review Period, the total Irish property portfolio was around €14.5 billion with a commitment for another €1 billion (in total about £12 billion), spread across property investment and development, construction, hotels and restaurants. Of its total property exposure, over 40% was to the higher-risk segments of property development and construction, in aggregate about £5.1 billion. Over 50% of the development exposure had interest roll-up facilities with a significant proportion already in use by the end of 2008; while over 50% of the exposure was also classed as land (about £2.5 billion), of which over half did not have planning permission. BOSI found itself particularly exposed as the oversupply of property became apparent, the market lost liquidity and the economy tipped into severe recession.

436. The property development exposure was almost 22% of the corporate portfolio and 15% of the total loan portfolio. This represented a reversal of the aim of the BOSI Board, which in June 2006 had expressed a desire to reduce the property development component to 10% of the total book. As a result, development exposures more than doubled from €2 billion to €4.8 billion in just over two years.

437. The Irish Financial Services Regulatory Authority limited property exposures to 250% of a bank's capital base.(78) However, in the case of BOSI this was disapplied as BoS, the UK bank, provided a guarantee that took the risk on to the UK balance sheet. This enabled the property exposures to grow excessively. At the end of 2007, the capital base of BOSI was around €2 billion, which implied a property limit of €5 billion, but the guarantee meant that actual property lending (excluding hotels and restaurants) was about €11 billion. Expectation of further property lending in 2008 led BoS to increase the size of the guarantee in late 2007. By the end of 2008, property lending had further increased to just over €12 billion.

438. BOSI's hotel lending (£1.2 billion) also found itself vulnerable to the downturn. Notwithstanding that the sector was in decline, BOSI's exposure was concentrated, making it higher risk: it lent on approximately one third of all hotels in Ireland by 2007 and seven borrowers accounted for 69% of its exposure by the end of 2008. Of these around a half were barely earning enough income to cover interest charges.

439. Lending was also often at 100% LTV. This left BOSI exposed to even a small fall in prices, let alone the significant falls that were actually experienced.

HBOSA commercial property

440. HBOSA, prior to the disposal of BankWest, had built a similar-sized property portfolio to Ireland (about £13 billion), with significant property development and construction lending. At around 55% of its corporate lending, commercial property also represented a higher proportion, and therefore created a more concentrated portfolio, than the average for Australian banks.

441. The disposal of BankWest roughly halved the property portfolio to around £6 billion, of which almost £3 billion was development and construction. These tended to be the poorer quality loans however, and were not capable of being sold at that time.

Large exposures

442. The size of the largest exposures in Australia, Ireland and ENA was generally much smaller than in Corporate, as would be expected given the smaller balance sheets in those geographies. For example, at the end of 2006, Australia's largest exposure was £200 million, Ireland's was £100 million and ENA's was £700 million. However, there were some noticeable changes in the period, including late in the cycle when the Group was looking to reduce growth:

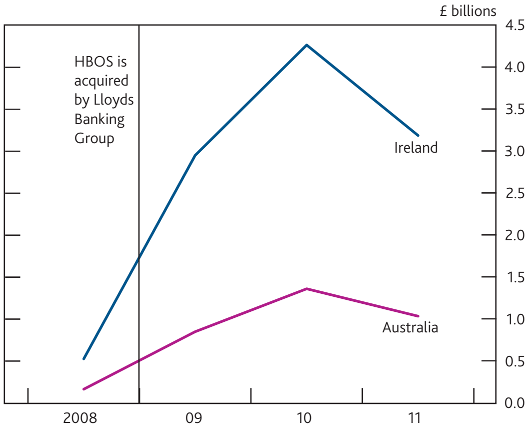
- in June 2008, Australia more than doubled its largest exposure to A$1 billion from A$300 million; which then doubled again in August to A$2.5 billion (about £1.2 billion); and

- between June and August 2007, Ireland significantly increased the value of the deals it was prepared to do, as new lending resulted in its top five exposures increasing from around €500 million in aggregate to around €2 billion.(79) As in the United Kingdom, the larger deals were heavily biased towards the commercial property sector. This was the result of a conscious decision in mid-2006 as the Group sought to build a corporate banking business following the UK ISAF/JV approach: '*This initial momentum has continued into 2007 with several big wins and healthy pipeline of substantial prospects.*'(80)

443. ENA was the most concentrated portfolio, with the top five corporate exposures representing almost 10% of the total portfolio by the end of 2007. In Australia and Ireland, the top five corporate exposures never accounted for more than 5% of the total portfolio.

(78) The regulator had two limits: a 200% sector limit and a 250% aggregate limit for sectors subject to a common risk. HBOS applied the aggregate limit to lending for property investment, property development and construction.
(79) Equivalent to £1.4 billion, translated at the average exchange rate for 2007.
(80) HBOS Board paper, Bank of Scotland (Ireland) Strategic Review.

Chart 2.43: Impairment losses in BOSI and HBOSA, 2008 – 2011[a]



(a) Source: HBOS and LBG *Annual Reports and Accounts* and Review calculations.

Risk capital

444. As set out in Table 2.15, the division had accumulated a sizable pool of equity and mezzanine stakes in joint ventures (typically with property companies) and venture capital funds. As set out in Section 2.4.6, capital and similar instruments are risky assets and a point of weakness as economies and their property markets dip, or in the case of Ireland, moved into severe recession.

Table 2.15: Risk capital by country as at summer 2008[a]

£ billion	Risk capital	Mezzanine	Total	£ Total
Australia	A$0.3	A$0.3	A$0.6	0.3
Ireland	€0.2	€0.1	€0.3	0.2
ENA	$0.4	$0.2	$0.6	0.3
				0.8
As % of group Tier 1				3%

(a) Source: Group Credit Risk Committee pack.

2.5.4 Losses in International

445. Losses in the International Division ultimately rose to £15.5 billion, of which £14.3 billion (or 94%) was incurred within Ireland (£10.9 billion) and Australia (£3.4 billion). The level of losses as a proportion of loans experienced in these jurisdictions (36% and 27% respectively) was higher than those experienced in the UK Corporate Division.

Table 2.16: Loan impairment losses in BOSI and HBOSA 2008 – 2011[a]

£ billion	Loans and advances (2008)	2008	2009	2010	2011	Total	Loss as % of 2008 balances
Ireland	30.7	0.5	2.9	4.3	3.2	10.9	36%
Australia	12.8	0.2	0.8	1.4	1.0	3.4	27%
TOTAL	43.5	0.7	3.7	5.7	4.2	14.3	33%

(a) Source: HBOS and LBG *Annual Reports and Accounts* and Review calculations.

446. The available information suggests that the underlying causes of the high losses were different in each jurisdiction.

Ireland

447. In Ireland, BOSI, like many other lenders, embraced the prevailing market confidence which dramatically disappeared as the financial crisis intensified, thus eroding many of the economic gains of the previous five years. BOSI's impairment losses grew from £22 million in 2007 to £2.9 billion in 2009 and £4.3 billion in 2010 as the Irish economy deteriorated and the Irish state required funding from the European Financial Stability Facility and the International Monetary Fund (announced November 2010).

448. Ireland was in many ways a more extreme version of the UK experience, resulting in higher loss rates. As the financial crisis took hold and liquidity in the market dried up, both residential and commercial property prices fell drastically – residential prices by around 50%(81) and commercial property by around 65% – contributing to both corporate and retail losses.

449. BOSI's losses were dominated by corporate lending, which accounted for 90% of all losses. Over 80% of BOSI's corporate assets became impaired, with less than 40% expected to recover. Around 15% of Irish retail assets have become impaired with recovery rates expected to be even lower.

450. As in the United Kingdom, the Irish corporate losses were due to a preponderance of commercial real estate lending: entered into at the height of the market; to large individual property developers who got into difficulties as the bubble burst; and on aggressive terms with weak security.

451. The retail portfolio trebled in size between 2005 and 2007 towards the top end of the market as the firm pursued its objective of significant market share. To gain market share many loans were offered on aggressive terms (i.e. high LTVs and low margins). The majority of the retail losses (around £1 billion) were incurred on the BTL portfolio.

452. The liquidation of two of Ireland's major banks and the transfer of real estate lending assets to the National Asset Management Agency (NAMA) make meaningful comparison with the loss experience of the major Irish banks difficult.

453. NAMA was established in 2009 and took over €74 billion of real estate loans(82) from the five biggest Irish banks and building societies (not including BOSI). These assets were then subjected to a discounting process, primarily determined by the value of the underlying property, such that the total value of these assets was reduced from €74 billion to €32 billion, or by 57%. By the end of 2011, NAMA had made impairment charges on its portfolio of €2.8 billion while realising a gain on disposal of €0.5 billion. In aggregate, this represented a further loss of around 3%, bringing the total reduction in the value of assets transferred to around 60%. BOSI's impairment experience in Ireland has been of a similar magnitude: around 63% of its impaired commercial property, and 64% of all its property lending at the end of 2011, was provided for.

454. A 2012 comparison of BOSI's retail mortgage portfolio compared to peers demonstrated that BOSI's portfolio had suffered similar or worse deterioration as the main Irish banks, particularly on measures of assets in negative equity and in arrears.

(81) Prices for apartments fell around 60%.
(82) The loans were mainly secured on commercial property but did include residential property lending.

455. While the macroeconomic downturn suffered in Ireland and the subsequently declining asset values played a very significant part in BOSI's loss experience, weak controls exacerbated the losses. The firm may also have been seen as a forced seller.

456. For example, BOSI allowed brokers and borrowers to choose which valuers from a panel were used to provide valuations on mortgaged properties. In an environment of rapidly increasing house prices, this gave rise to over-inflated valuations which BOSI then relied on in making lending decisions. A study in 2009 by BOSI found that the security, based on a small sample, had been over-valued and the bank now faced an average potential loss of €488 thousand per loan. While this study undoubtedly highlighted a sample of extreme cases, it demonstrates that BOSI relied on some external valuers who may have provided unreliable valuations.

457. Within the corporate portfolio, a 2009 file review covering 37% of the outstanding portfolio found there to have been widespread failings in credit controls pre-2009. These included: insufficient challenge of credit proposals within both BOSI and centrally within International; evidence of credits being sanctioned despite indications that the client was untrustworthy or that the sanctioning authority did not understand the submission; limited annual review of existing loans; credit files rarely complete or not containing up-to-date relevant information; 100% LTVs; and the use of internal valuations by BOSI rather than independent professional valuations, even for highly specialised areas such as petrol stations and wind farms. The review noted that some of these valuations included 'hope value' – i.e. optimistic assumptions made about the use of land when planning applications had already been rejected – when, as Ms Jo Dawson(83) noted: '*In Ireland it was these are fields with sheep in them and their re-use is fields with sheep in them*'. Generally, too much reliance was placed on the continued growth in the economy and security values.

Australia

458. The financial crisis did not affect Australia in the way it did Europe and the United States. However, commercial property and house prices fell significantly in certain areas, in particular north and south east Queensland in Australia and also in New Zealand. A loss of liquidity as few potential investors were able to secure funding and a glut of available property exacerbated the price falls.

459. In Australia, a drive for market share, particularly in corporate lending, led HBOSA to support transactions with high inherent risks. Therefore, while Australian banks generally suffered lower losses in the years subsequent to the Review Period, HBOSA's loss record was significantly worse.

460. Chart 2.44 shows that while all four major Australian banks suffered losses in the financial crisis, HBOSA fared particularly badly, with a cumulative loss rate of over 8% between 2008 and 2011 – this compares to a range between 2.0% to 3.1% for the main Australian banks.

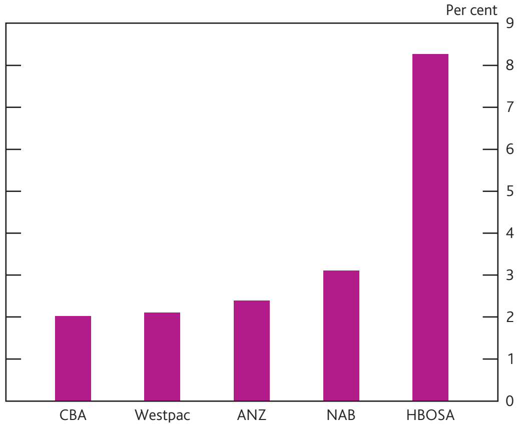
461. The reasons for HBOSA's significantly poorer loss experience compared to the major Australian banks arose from both the nature of HBOSA's lending and the difficulty of reducing exposures following the failure of the Group.

462. HBOSA had a lending portfolio which was markedly concentrated in commercial property. HBOSA also lent against high-risk real estate, such as land banks, or in poor quality locations. While other Australian banks had also lent in these areas, they had ensured this type of lending made up only a small part of their portfolio(84), whereas HBOSA had actively targeted these regions.

(83) Ms Dawson was Chief Executive of HBOS's Insurance and Investment Division in 2008. Following acquisition by Lloyds TSB, she became Director of Wealth and International within LBG.
(84) See the RBA's March 2010 Financial Stability Report for a comment on the lending practices of major Australian banks compared to overseas banks.

2

Chart 2.44: Australian banks' cumulative losses 2008 – 2011, as percentage of 2007 loans and advances(a),(b)



(a) Source: *Annual Reports and Accounts* and Review Calculations.
(b) To enable a more meaningful comparison, losses have been measured against 2007 loans – i.e. before HBOSA disposed of BankWest.

463. In addition to making poor quality loans in high risk areas, HBOSA had regularly held the most junior debt tranches and sold higher quality tranches on to other banks, thus increasing their risk of loss in the case of a default. In interview Ms Dawson said she had reviewed some of the loans after the LBG acquisition: '…*in particular, there were, we discovered in the book, a significant number of poorly thought out and structured property deals in North Queensland which, with the benefit of hindsight, or even probably at the time, would appear highly speculative*'.

464. It also appears that normal credit application controls, that may have prevented some of the losses, were not followed: '… *when I* [Ms Dawson] *was doing the role in Lloyds Banking Group I was out in Australia quite frequently and met with the recovery agents we used…. And some of the things they described about the nature of the propositions and how – certainly it seemed to me that these were things that people would have considered through any normal credit application process, which clearly hadn't been considered….*'

465. HBOSA's push for market share often meant it took on the poorer assets others did not want. Ms Dawson in interview explained: '*We had reports from the Australia business, or from the Chief Executive of the International businesses, which often spoke about our success in winning a large share of business. And I think my reflection would be, having seen that subsequently, is that we hadn't realised that we were succeeding potentially not because of superior skills but because of adverse selection*'.

466. Furthermore, many Australian customers did not have long-term relationships and other products with HBOSA, and therefore had little incentive to maintain the relationship or work consensually through issues.

467. In contrast, the major Australian banks were able to take a more balanced and long-term portfolio view of poorly performing assets, which formed a much smaller part of their portfolios. They also tended to have higher collective provisions than HBOSA, and so the financial impact of these assets was further limited.

468. In September 2008, a Board paper reported that HBOS had made it clear to the markets it was a willing seller of its overseas operations, as it sought to alleviate its funding pressures. This would put downward pressure on any asset sales by HBOS.

2.6 Asset quality – Retail Division

2.6.1 Introduction

469. The purpose of this section is to consider the nature and quality of the assets and business of the Retail Division:

- Section 2.6.2 sets out the strategy of the division during the Review Period;
- Section 2.6.3 reviews the performance of the division, including the growth and composition of the division's assets;
- Section 2.6.4 compares the division's mortgage portfolio with peers; and
- Section 2.6.5 considers the losses incurred by the division between 2008 and 2011 and how they compare to peers.

2.6.2 Divisional strategy

470. After the merger between Halifax and BoS, HBOS's Retail Division was a market leader in UK mortgage lending, but was keen to expand its business in other products.

471. In the years immediately following the merger, Retail gained market share through offering competitive products in the current account, credit card and investment areas. The merger also allowed significant cost savings to be achieved, while the rapid rise in house prices between 2001 and 2004 boosted growth in mortgages and related products.

472. The key elements of the Retail business strategy were:

- in line with the overall business strategy, the division aimed to build or hold a market share of between 15% and 20% in its core markets. It had already attained this in mortgages and savings, but sought to do so in the current account and, less successfully, SME markets;
- strong customer value proposition – the firm aimed to offer simple and competitively priced products to increase market share, what it referred to as 'hero' products;
- customer service – good customer service would help to retain customers. The firm acknowledged that it sometimes struggled to deliver the quality of service it aspired to;
- cross sales – selling to existing customers would enhance profitability and was a key reason for attempting to improve customer share in the current account market. The bank attempted to be more customer friendly than its competitors and to offer good value products that would be attractive to its client base;
- multi-brand approach – in mortgages, Halifax was the mainstream, mass market brand, with Birmingham Midshires and The Mortgage Business catering for specialist mortgages and

Intelligent Finance offering internet banking. BoS continued the legacy 'BoS' brand. HBOS also offered credit cards under the Halifax, BoS and Sainsbury's Bank labels;

- cost control – cost increases would be kept significantly below revenue growth; in the early years, this was assisted by merger synergies; and

- margin management – HBOS used base rate changes to widen margins and claw back some of the lost revenue from its aggressive up front pricing.

473. In 2004, the Retail Division took on additional responsibility for SME lending to businesses with less than £1 million turnover, with branches' capacity to handle small business banking being enhanced.

474. After 2005, the pace of growth slowed. In its Group Business Plan 2005 – 2009, HBOS senior management saw a softening in the retail landscape going forward. Recognising that revenue synergies from the merger had been largely exhausted, it also believed that market conditions had changed. Having experienced a period of rapid growth in house prices and consumer credit, its central economic scenario forecast was for a fall of 20% in house prices over a three year period and growth in consumer credit of 3-4% annually, leading to a correction in the house-price-to-earnings ratio closer to its long term average.

475. Another challenge was pressure on margins. Throughout the Review Period, intense competition in the mortgage market, particularly driven by the smaller mortgage banks such as Northern Rock, Alliance & Leicester and Bradford & Bingley meant that margins had fallen, while LTVs and loan-to-income multiples had risen, and customer churn had increased. Firms were also beginning to anticipate the introduction of Basel II, expecting a reduced capital cost of mortgages, especially for firms adopting the internal models approach, which would facilitate tighter margins.

476. In 2006, house prices had not fallen and were no longer expected to fall by Retail, while concerns about the level of churn and its impact on profitability led to a shift in strategy by the division. To improve customer retention, the division sought to increase the pricing of new business while reducing the pricing of its back book, to pay procurement fees to brokers when a mortgage was retained, and to contact customers coming to the end of the initial fixed period to advise them of retention offers.

477. This strategy, pursued from mid-2006 to early 2007, was ultimately unsuccessful. The book proved particularly prone to churn, due to the nature and level of broker-introduced business; the communications strategy encouraged customers to shop around for the better deals, increasing churn; and competitors failed to adjust their pricing causing HBOS's share of new lending to fall, especially in mainstream mortgages. The division's immediate response was to chase net new lending through aggressive short-term fixed rates, but this merely increased the pressures on future margins.

478. The Group Business Plan 2008 – 2012 envisaged a much lower net lending market share (9% market share in 2008 compared to 20.9% for 2007) while gross lending projections were also reduced slightly (from 21.9% to 21.2%). With increasing concerns about funding, efforts to grow retail deposits intensified.

479. At the end of 2007, the retail business consisted of the following areas:

- mortgages – HBOS was the market leader with about 20% of the market;

- savings – with around 16% of the market;

- banking – with a 13% share of the current account market;
- personal loans and credit cards – with market shares of 10% and 9% respectively;
- business banking (i.e. commercial businesses with less than £1m turnover) – with a 5% market share; and
- other retail services – HBOS had a joint venture with Sainsbury's and provided a variety of other products such as estate agency, valuation and share dealing.

2.6.3 Performance

480. Table 2.17 and Table 2.18 show key financial metrics for the Retail Division over the Review Period.

Table 2.17: HBOS Retail key profit and loss metrics[(a),(b),(c)]

£ billion	2004	2005	2006	2007	2008
Net interest income	3.7	4.0	4.2	4.1	4.2
Non-interest income	1.2	1.3	1.4	1.3	1.3
Operating expenses	(2.3)	(2.5)	(2.2)	(2.3)	(2.1)
Impairments	(0.6)	(1.0)	(1.1)	(1.3)	(2.2)
Other	0	0.1	0	0.1	0.1
Profit before tax	**2.0**	**1.9**	**2.3**	**1.9**	**1.3**
NII margin %	1.85	1.84	1.78	1.66	1.66
Cost income ratio %	43.6	39.8	38.4	39.7	36.7
Impairment loss/L&As %	0.34	0.47	0.48	0.53	0.88
Return on assets %	1.1	0.9	1.0	0.8	0.5

(a) Source: HBOS *Annual Reports and Accounts* and Review calculations.
(b) 2004 is the comparative from the 2005 *Annual Report and Accounts* to reflect the introduction of IFRS in 2005.
(c) Non-interest income is predominantly net fee and commission income.

481. Having experienced rapid growth prior to 2004, profit before tax stayed relatively constant despite the increase in assets. While the firm did make some progress in managing its costs, this was outweighed by increasing impairments, which roughly doubled from £0.6 billion in 2004 to £1.3 billion in 2007, and then rose to £2.2 billion in 2008, as the crisis took hold.

482. The performance of Retail began to deteriorate in 2007. While strong competition had led to a general decline in mortgage rates, Board papers attributed the poor performance in 2007 to both the quality of business written during the period of rapid growth that the division pursued in the aftermath of the merger, as well as developments in the market. In particular:

- a significant part of the impairment loss was in the unsecured book. This book had underperformed for a while, both in terms of margin and rising impairments. This was attributed to margin erosion through competition, sub-optimal lending decisions as too much focus was placed on the bundled sales of a loan with a PPI product, and regulatory change (i.e. the ease with which Individual Voluntary Arrangements could be obtained); and

2

- mortgage attrition rates or churn[85] were higher than expected, negatively affecting profitability over the long term, although this had contributed to the appearance of strong performance in the early years (i.e. pre-2006 and 07).[86] The high churn rates were attributed to writing larger deals (e.g. 'jumbo' loans greater then £350,000) and reliance on intermediaries.

483. Conduct issues also played a role. While PPI mis-selling costs did not materialise until later,[87] the division had not been immune to earlier conduct and mis-selling issues (for example, in 2007 it provided £122 million for ex-gratia refunds of unarranged over-draft charges; and between 2004 and 2006, £485 million for mortgage endowment compensation). In addition, an Office of Fair Trading ruling resulted in reduced credit card fees being levied in 2006. This was in no small part the reason for the FSA supervision team's focus on conduct matters (see Section 4.3.2, '*Supervision of asset quality in the Retail Division*').

484. As a result of these factors, return on assets declined significantly, falling from 1.1% in 2004 to below 0.5% in 2008. As such, the division became increasingly vulnerable to shifts in its income or costs. A relatively small reduction in net interest margin would wipe out its remaining profit. Poor performance by Retail was one factor which led to increased profit targets in Corporate in 2007 and so indirectly led the Group to take on more risky exposures in other areas of the business.

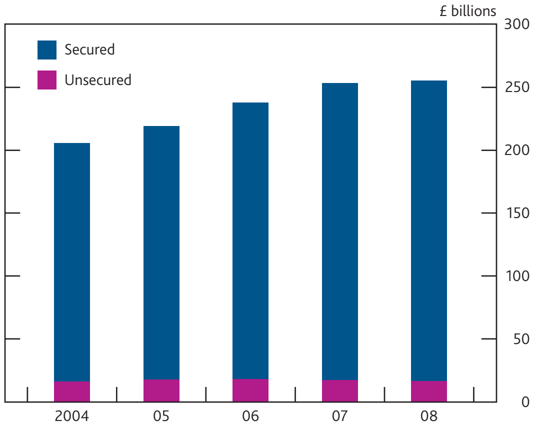
Table 2.18: HBOS Retail key balance sheet metrics[(a),(b)]

£ billion	2004	2005	2006	2007	2008
Total assets	209	225	243	260	266
Loans and advances	206	219	238	253	255
Other assets	3	6	5	7	11
Impaired loans/L&As %	2.2	3.0	2.7	2.6	3.6
Impairment provisions/impaired loans %	35	30	33	34	33
Risk weighted assets[(c)]	104	109	112	118	74
Deposits	128	132	145	158	144

(a) Source: HBOS *Annual Reports and Accounts* and Review calculations.
(b) 2004 has been adjusted to reflect the implementation of IFRS in 2005.
(c) Calculated under Basel I until 2007, then under Basel II, which gave rise to a fall in the mortgage risk weights.

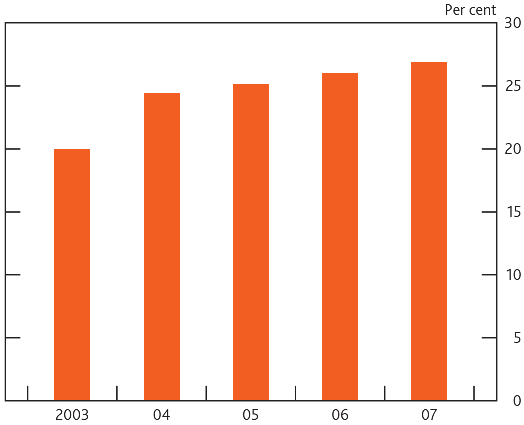
(85) The average duration of loans was three years.
(86) The division overestimated the time that loans would be on higher administered rates compared to discounted introductory offers, and so overestimated the annual average income over the life of the loan: this led to too much income being recorded in the introductory period.
(87) HBOS provided £3.4 billion between 2011 and 2014.

Chart 2.45: Outstanding loans and advances, Retail Division(a)



(a) Source: HBOS *Annual Reports and Accounts*.

Chart 2.46: Share of specialist lending in HBOS's portfolio(a)



(a) Source: HBOS *Annual Reports and Accounts*.

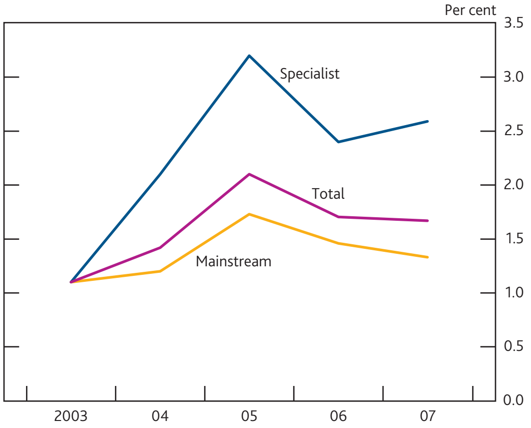
485. The vast majority of the Retail balance sheet was made up of retail mortgages as shown in Chart 2.45. Unsecured lending was a small and diminishing fraction of the total as HBOS became concerned about the risks, given an increase in arrears and losses starting in 2005. On a risk-adjusted basis, the unsecured lending represented a larger proportion of the balance sheet, given the high loss rates experienced in in this type of lending. Nonetheless, under Basel II, mortgage RWAs still represented 60% of the total retail RWAs.

486. To improve its margins, HBOS expanded its mortgage activities in less competitive areas, such as self-certification and BTL mortgages, where margins were higher and turnover lower. By 2007, 27% of mortgage lending exposure was in specialist lending (Chart 2.46), almost half of which (i.e. around 14% of the total mortgage book) was in self-certification mortgages, although there had been little growth over the Review Period, remaining around £30 billion. The BTL mortgage portfolio was the area of real growth, almost doubling to £27 billion between 2006 and the end of 2007, where maintaining market share also meant moving up the risk curve (e.g. in January 2007 HBOS reduced the minimum rental cover(88) it was willing to accept to 100%). Sub-prime was the smallest part, marginally decreasing to about £4.5 billion by the end of 2007.

(88) Rental cover is a certified rental amount as a percentage of the mortgage payment, when the mortgage is granted. Rental cover of 100% means there is no spare buffer to cover any potential rise in the mortgage interest rate cost or rental voids (i.e. unoccupancy).

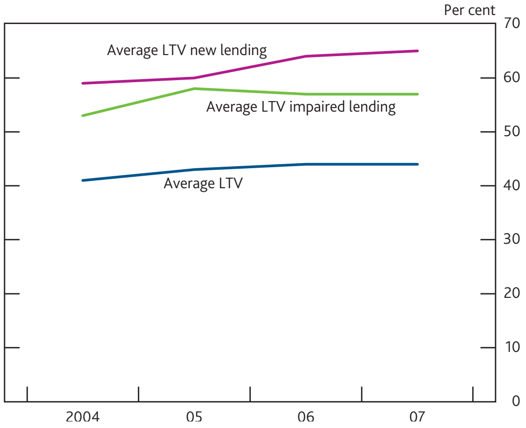
2

Chart 2.47: HBOS mortgage arrears as a percentage of drawn balances(a)



(a) Source: HBOS *Annual Reports and Accounts*.

Chart 2.48: HBOS portfolio loan to value ratios(a)

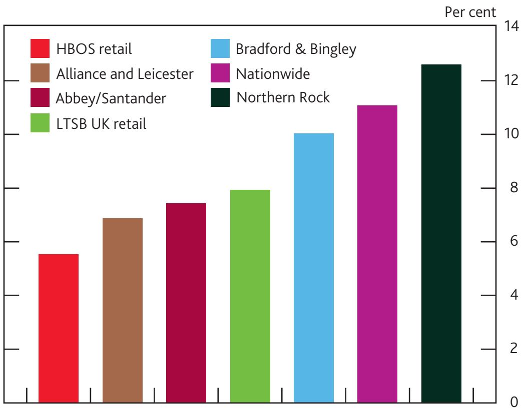


(a) Source: HBOS *Annual Reports and Accounts*.

487. While specialist lending had similar arrears levels to mainstream mortgages in 2003, this gradually changed, and approximately doubled by 2007, contributing to an increased total arrears level (Chart 2.47).

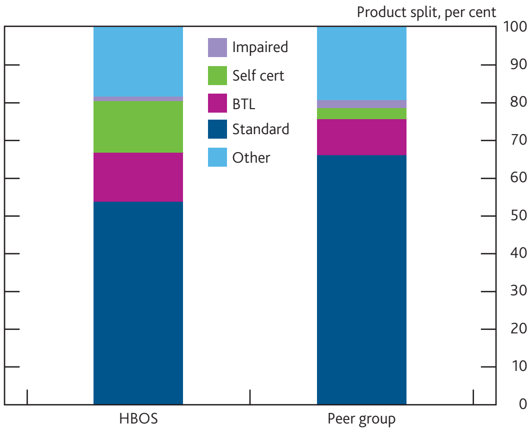
488. In retail mortgages, the group gradually increased its average LTV on new lending over the Review Period. The firm kept its average portfolio LTV relatively constant over time, with increasing house prices reducing the LTV for the back book (Chart 2.48).

Chart 2.49: Annualised asset growth rates 2004-2008[(a)]



(a) Source: HBOS *Annual Reports and Accounts* and Review calculations.

Chart 2.50: Mortgage balance composition by product, June 2008[(a),(b)]



(a) Source: Firm regulatory reporting to the FSA and Review calculations.
(b) Other mortgages tend to be older mortgages and are largely mainstream in nature. The peer group includes Lloyds TSB, Alliance and Leicester, Bradford and Bingley, Santander and Northern Rock.

2.6.4 Peer comparisons

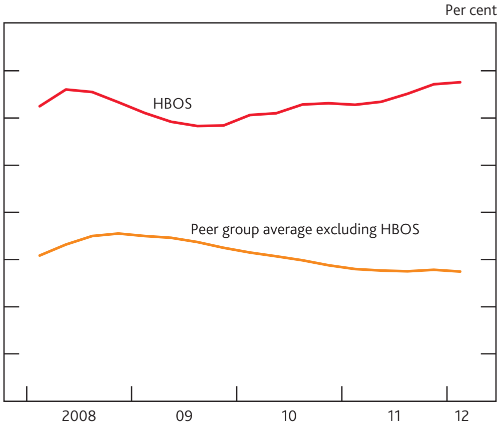
489. Although there are challenges in comparing somewhat different businesses, HBOS's retail balance sheet grew more slowly than many of its competitors between 2004 and 2008 (Chart 2.49).

490. A comparison of the total balance of HBOS's lending to its peers (Chart 2.50) indicates a bias towards self-certification and BTL mortgages. In aggregate these types of lending comprised 27% of HBOS mortgage portfolio, compared to an average of 12% for its peers.

491. In addition, around 50% of HBOS's mortgages were interest only, against 34% for the peer group, and an increase from 43% in June 2006. Such loans are generally considered more risky as there is no reduction in the value of the outstanding loan over time while final repayment is often dependent upon house prices rising or remaining steady. At 60% of the market, the division also estimated it had a significantly larger proportion of 'jumbo loans' than its peers.

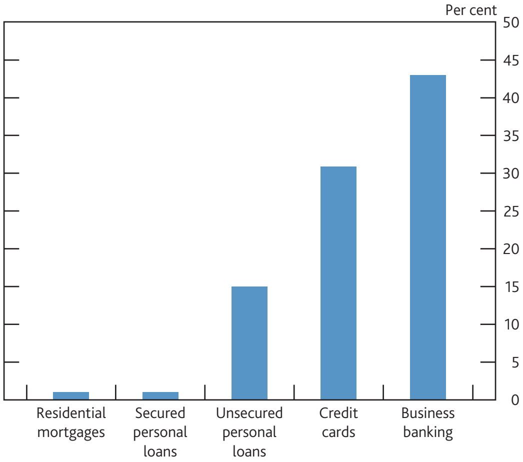
2

Chart 2.51: Arrears rates among mortgage lenders(a)



(a) Source: Firm regulatory reporting to the FSA and Review calculations.

Chart 2.52: 2008-2011 impairments as a percentage of 2007 year end loans and advances(a)



(a) Source: HBOS regulatory reporting to the FSA and Review calculations.

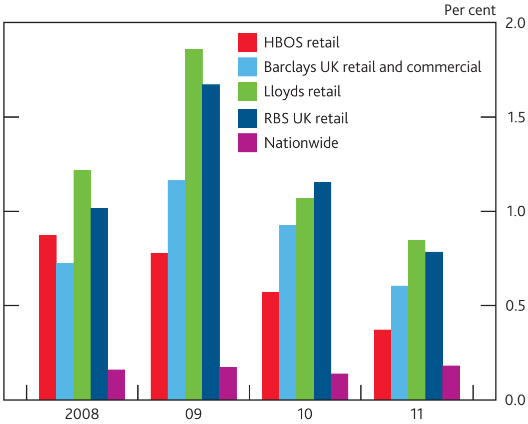
2.6.5 Losses in Retail Division

492. Overall, the firm suffered relatively modest losses on its retail portfolio, with 1% cumulative impairments on its residential mortgage portfolio between 2008 and 2011 and 3% on its total retail portfolio. As a result, the Retail Division remained profitable in its worst impairment year (2008), when it suffered a total £2.2 billion impairment charge.

493. However, it is likely that impairments for the industry as a whole were reduced by the Bank of England's decision to lower interest rates in a series of large downward moves, culminating in a base rate of 0.5% in March 2009. Notwithstanding a rise in unemployment and fall in average earnings, this supported house prices, which had been falling in the second half of 2007 and 2008, by keeping interest repayments low and mortgages affordable.

494. Retail mortgages saw cumulative impairment losses between 2008 and 2011 of £2.4 billion, unsurprising given mortgages were the largest part of the balance sheet. The loss rate was, however, the lowest of the various retail business lines (Chart 2.52). The second highest losses came from the credit card business at £2.1 billion. While this was 31% of total credit card lending, this should be considered in the light of the much higher margins charged for this business. The highest loss rate was experienced in business banking, although on lending of £1.5 billion the absolute loss was one of the smallest.

Chart 2.53: Retail impairments as a percentage of 2007 balances[(a)]



(a) Source: *Annual Reports and Accounts* and Review calculations.

495. Impairments do not look out of line with other large UK retail lenders (Chart 2.53). The composition of different banks' retail businesses varies however, and losses will have been affected by the different growth rates and lending policies pursued after 2007.

496. Overall, HBOS had a lower level of impairment charges as a percentage of its retail book than its main competitors, except Nationwide. This was driven by the fact that HBOS had a much higher level of mortgages as a proportion of its balance sheet than the other firms, except Nationwide. For example, at end 2008, 93% of the HBOS Retail balance sheet comprised mortgages, compared with 64% for RBS UK Retail Banking, 86% for Barclays UK Retail and 75% for Lloyds TSB Retail. Mortgages tend to experience much lower loss rates than other retail lending such as credit cards and personal loans, leading to a lower overall loss rate for HBOS. This was despite the fact that both in mortgage and non-mortgage lending HBOS had higher arrears and consequently impairments as a proportion of advances. The rate was 0.5% in mortgages compared to 0.04% for RBS and 0.2% for Lloyds TSB. For non-mortgage lending it was 6.6%, while others experienced 3.8% (RBS) and 4.6% (Lloyds TSB).

2

2.7 Asset quality – Treasury Division

2.7.1 Introduction

497. The purpose of this section is to consider the nature and quality of the assets and business of the Treasury Division, and the extent to which these contributed to the failure of HBOS.

498. Treasury assets were primarily intended to act as a source of liquidity, although the division also took investment positions and some small trading positions. The HBOS Board agreed in 2004 to a change in the risk appetite for Treasury and endorsed a move in the constitution of the portfolio from a majority of gilts to AAA-rated securities enabling it 'to retain the high credit rating and generate yield'.

499. Effective valuation methods are critical to ensuring that credit risk in an investment portfolio is adequately managed. Although the majority of the asset-backed securities (ABS) portfolio was externally rated, this did not mean there was a deep and liquid market for these assets. For the majority of the Review Period, external marks would have been available to verify internal valuation estimates. However, as the financial crisis deepened HBOS was increasingly reliant on internal marks. In April 2008, the FSA benchmarked HBOS's valuations against two other large firms with significant ABS portfolios. The analysis showed that HBOS was systematically valuing ABS assets more highly than the other two institutions. The report concluded: *'There is strong evidence, therefore, that the firm has been slow to reflect current market pricing into its valuations'*.

500. In 2008 the Treasury asset portfolio exposed HBOS to a high level of market and credit risk and, when market sentiment turned against these assets, contributed to the shortfall in funding that occurred.

501. The Treasury business unit incurred significant impairments and negative fair value adjustment losses during 2008 as a result of the declining market values of asset backed securities. Negative fair value adjustments and impairment losses with a combined value of £8.6 billion, amounting to some 10% of the Treasury asset portfolio, were incurred during 2008.

502. However, over a longer term horizon the performance of the division was more mixed. While losses and write-downs on assets were incurred, notably in 2008 and 2009, the losses subsided thereafter, due to a mix of market movements and asset disposals. In addition, the accounting treatment applied to these assets over the years 2008-2009 has resulted in certain increases in their market value remaining unrecognised in the income statement.

Table 2.19: Cumulative impact of the estimated main gains and losses of the Treasury Division[a]

£ billion	2008 – 2012
Estimate of trading gains/(losses)	(1.4)
Impairment losses on AFS assets and debt securities	(7.3)
Estimated gains/(losses) on AFS assets	0.5
Unrecognised gains/(losses) on trading and AFS assets	5.0
Net loss	**(3.2)**
As a percentage of total Treasury debt securities as at 31 December 2007	**4.0%**

(a) Source: HBOS *Annual Reports and Accounts* and Review calculations.

503. HBOS's divisional structure ceased to exist following the acquisition by Lloyds TSB. While the majority of the reported results presented in this section relate to the assets of the HBOS Treasury Division, there is a small element that is attributable to the assets of the other divisions in post-acquisition years, notably the Corporate Division which had equity, debt and fund investments.

2.7.2 Balance sheet assets

504. As at the end of 2008, the division had £147 billion of assets, up from £120 billion in 2007, including Government securities, bank securities in the form of floating rate notes (FRNs), certificates of deposit (CDs), and various ABS. Table 2.20 shows a further breakdown of the debt securities and the accounting classification.

Table 2.20: Analysis of the debt securities in the Treasury Division[a]

£ billion	December 2007	June 2008	December 2008			
	All	All	Trading	Available for sale	Loans and receivables	Total
ABS						
Direct	23.3	21.2	3.0	–	20.5	23.5
Grampian[b]	18.6	16.2	–	–	16.7	16.7
Covered Bonds	3.2	3.2	–	4.1	–	4.1
Bank FRNs	17.4	17.3	1.9	16.0	–	17.9
Bank CDs	15.3	13.8	3.1	2.9	–	6.0
Other[c]	3.4	3.9	6.0	2.5	–	8.5
Total	**81.2**	**75.6**	**14.0**	**25.5**	**37.2**	**76.7**

(a) Source: HBOS *Annual Reports and Accounts*.
(b) Grampian was a special purpose vehicle sponsored by HBOS that invested in asset-backed securities and funded them by issuing commercial paper.
(c) Including governments and supra-nationals (per 2008 interims).

505. Table 2.21 shows a further breakdown of the ratings of the ABS portfolio. This was the highest risk part of the Treasury balance sheet, yet in mid-2008 the majority of the ratings were in the range AAA – A, with AAA being the dominant rating. There had been a small drift by the year end but the assets were still on average rated AA. Notwithstanding the subsequent criticism of the ratings agencies, this would have been considered a high-quality portfolio at the time.

2

Table 2.21: Distribution of the ratings of the ABS portfolio by grade as at 30 June 2008[a]

	Nominal £ billion	AAA – A Percentage of portfolio	BBB or worse Percentage of portfolio
US RMBS			
Prime	2.0	94.4	5.6
Alt-A[b]	6.6	99.7	0.3
Sub-prime	0.1	98.2	1.8
Non-US RMBS	7.8	100	0
CMBS	3.3	100	0
CBO	3.4	96.6	3.4
CLO	3.2	100	0
Personal sector			
Auto loans	1.4	97.1	2.9
Credit cards	2.9	100	
Personal loans	0.9	100	
FFLEP student loans	5.6	100	
Other ABS	0.7	83.3	16.7
Negative basis	3.3	88.9	11.1
Totals (30 June 2008)	**41.2**	**98.2**	**1.8**
Totals (31 December 2007)	**42.4**	**100**	**0**

(a) Source: HBOS *Annual Report and Accounts* 2007 and *Interim Results* 2008.
(b) Alt-A securities are securitisation notes, the credit quality of whose underlying mortgages is between 'prime' and 'sub-prime', a category sometimes described as 'near prime'.

2.7.3 Performance

506. The accounting classification determined how the performance of the debt securities was reported:

- items held for trading and/or designated at fair value at origination were carried at fair value with the gains or losses arising from the fair value revaluations being recognised as trading gains or losses in the income statement;

- available for sale (AFS) items were carried at fair value with the gain or loss recognised in a separate reserve on the balance sheet, rather than in the income statement. If there was an impairment of the item, the impairment loss would be recognised in the income statement; and

- loans and receivables were carried at amortised cost[89], adjusted to recognise any impairments in the income statement. To the extent the fair value or market value of these items changed that did not impact the income statement or shareholders' funds in any way.

507. In October 2008, the European Union endorsed the International Accounting Standards (IAS) Board's amendments to IAS39 for use by European listed companies. This clarified that, in certain exceptional circumstances, it was appropriate to reconsider and potentially alter the classification of certain assets. In common with many other firms, HBOS took the opportunity to review the classification of its assets and, on the basis that there had ceased to be an active market, made the following changes:

- on 1 July 2008, certain ABS and FRNs with a fair value of £9.1 billion and £3.1 billion respectively, were transferred from trading to AFS;

(89) Under the amortised cost basis, the value of an asset at any date is its initial cost plus or minus the cumulative amortisation up to that date of any difference between the cost and the maturity amount.

- on 1 November 2008, a portfolio of ABS with fair value of £35.4 billion was reclassified from AFS to loans and receivables; and
- in January 2009, £1.8 billion and £0.6 billion of debt securities were moved from trading and AFS, respectively, to loans and receivables.

508. The effect of the changes was that further changes in market prices of the debt securities need not be recognised immediately in the profit or loss account or directly in equity. To the extent the assets became impaired, the impairment would still need to be recognised as a loss in the income statement.

Impairment losses on debt securities and AFS assets

509. Since acquisition, HBOS's divisional structure has been aligned with that of LBG and it no longer reports its results as per its prior divisions. Nevertheless, the majority of the impairment losses on AFS assets and debt securities can be attributed to the securities held by the Treasury Division.(90)

510. In the period from 2008 to 2012, HBOS reported £7.3 billion of impairments on debt securities and AFS assets (Table 2.22). There was no significant loss on disposal of AFS assets; rather disposals realised small gains. The main impairment losses were incurred in the early years, and have tailed off as markets have partially stabilised.

Table 2.22: Analysis of reported impairments losses on AFS and debt securities 2008 to 2011[a]

£ billion	2008	2009	2010	2011	2012	Cumulative
Total impairments	2.9	2.8	0.5	0.7	0.4	7.3

(a) Source: HBOS *Annual Reports and Accounts*.

511. With the exception of loans and advances to customers (being the assets of the other divisions) the Group has not reported any impairment losses on its other exposures.

Recognised gains/losses on trading and AFS assets

512. In 2007, HBOS Group recorded net trading income of £178 million but took a £429 million write-down on its AFS assets, primarily from the activities of the Treasury Division.

513. As 2008 progressed and the markets became increasingly illiquid and dislocated, the market values of many debt securities fell, resulting in significant losses being recorded on trading and AFS assets. For the six months to 30 June 2008, HBOS in its interim financial statements recorded a £1.1 billion trading loss and a £2.7 billion write-down on its AFS assets, in aggregate a £3.8 billion write-down due to falls in market values.

514. Following the transfer of a substantial portion of the trading assets to loans and receivables in 2008 (pre and post failure), it is estimated that the Treasury Division's debt securities were about 60% of HBOS's trading assets and around 15% of its total assets carried at fair value. The trading portfolio was then significantly run down over the next three years.

515. Between 2008 and 2012, the Group reported a trading loss of £1.4 billion, although the majority of this loss was incurred in 2008 and 2009, with the Group making a profit between 2010 and 2012.(91) A significant part of this loss can be attributed to the Treasury Division.

(90) The Corporate Division incurred impairments on debt securities of £0.7 billion in 2008.
(91) Net of trading gains on foreign exchange of £517 million.

516. Between the beginning of 2008 and the end of 2012, the AFS reserve shows a marginal net gain of £188 million across the total AFS portfolio. However, across the five years a lot has happened. The AFS portfolio suffered a significant write-down in 2008 of £6 billion (after tax), but then experienced a recovery in 2009 with a gain of £1.9 billion. Thereafter, gains and losses were negligible. Subsequently, the net write-down was substantially recognised as impaired and transferred to the income statement. Finally, the Group realised £471 million (net of tax) of gains on disposals, primarily in 2011 and 2012.

Unrecognised gains/losses – assets reclassified from trading and AFS to loans and receivables

517. As at the end of 2008, the reclassification of assets from trading and AFS to loans and receivables meant the Group had not recorded potential gains on its assets of £1.7 billion, of which £1 billion would have been recognised in the profit and loss account on trading assets: this would have contributed to a reduction on the overall reported loss for 2008. The cumulative impact of the unrecognised gain between 2008 and 2012 is £5 billion: see Table 2.23.

Table 2.23: Analysis of the additional fair value gains on transferred assets[a]

£ billion	2008	2009	2010	2011	2012	cumulative
Total additional fair value gains not recognised	1.7	2.1	0	0.2	1.0	5.0

(a) Source: HBOS *Annual Reports and Accounts*.

2

2.8 Funding and liquidity

2.8.1 Introduction

518. On 1 October 2008, the Bank of England provided HBOS with ELA so that the firm would be able to continue to meet its liabilities as they fell due. It was no longer able to meet its needs from the wholesale market and was facing a withdrawal of customer deposits. The objective of this section is to investigate the extent to which HBOS's funding and liquidity strategy contributed to its vulnerability.

519. The section begins by considering the structure of the firm's funding in the pre-crisis period, the structured vehicles that it sponsored and the composition of its liquidity portfolio. It then considers how the closure of the structured finance and wholesale credit markets affected HBOS and the key events which triggered the liquidity crisis that led to the firm's increased dependency on central bank funding. The section concludes with an assessment of the Basel III liquidity framework and considers whether or not these measures would have been sufficient to prevent the failure of HBOS had they been in place at the time.

2.8.2 Funding structure: did the firm's structural funding position make it more vulnerable to liquidity risk?(92)

520. Chart 2.54 shows the liability structure of HBOS's balance sheet and how it developed during the Review Period. Over the three years to 31 December 2007, the balance sheet grew from £477 billion to £667 billion, a compound annual growth rate of 12%. Customer deposits grew annually on average by 9%, deposits by banks by 11% and debt securities in issue by 16%. At the end of 2007, customer deposits represented 38% of total liabilities, having fallen from 41% three years earlier. It is clear that, over the Review Period, HBOS became increasingly reliant on wholesale funding to finance its customer-lending activities.

How HBOS funded its lending activities

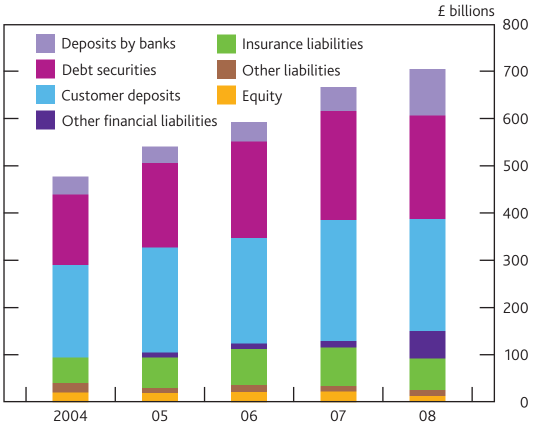
521. As shown in Chart 2.55, HBOS was not a particular outlier in the proportion of its total balance sheet that was funded in the wholesale markets; it was, however, an outlier (second only to Northern Rock) in the extent to which wholesale markets funded its customer loan book.

522. In the pre-crisis period, HBOS had the largest 'customer funding gap' – the amount by which customer loans exceed customer deposits – of all the major UK banks in absolute terms (see Chart 2.56).

(92) The charts in this section are derived from two sources: the published annual financial statements (which give the complete picture of the consolidated balance sheet) and internal HBOS management information (which contains granular analysis of the composition of funding). These datasets are prepared on different bases and so cannot easily be reconciled. So, for instance: (i) the two ABCP conduits are included in the financial balance sheet but will only appear in the internal information from the point at which HBOS began to fund them; (ii) 'customer deposits', as reported in the financial statements, includes money market funding from non-bank counterparties, which appears as wholesale funding in the management information. For the purposes of peer comparisons, Nationwide Building Society, whose year end is 4 April, is included as if its year end were the preceding 31 December (so, for instance, the '2008' figures for Nationwide are actually those as at 4 April 2009).

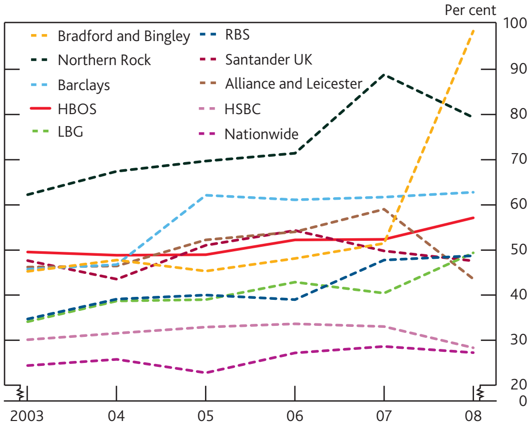
2

Chart 2.54: The liability structure of HBOS's balance sheet[(a)]



(a) Source: HBOS *Annual Reports and Accounts*.

Chart 2.55: Wholesale funding as a proportion of total funding[(a)]



(a) Source: *Annual Reports and Accounts*.

523. A standard relative measure of the gap is the loan to deposit ratio: customer loans divided by customer deposits. In the years leading up to the financial crisis, the growth in lending by many of the major UK banks outstripped the growth in customer deposits, resulting in a rising loan to deposit ratio and an increasing requirement to tap the wholesale markets.

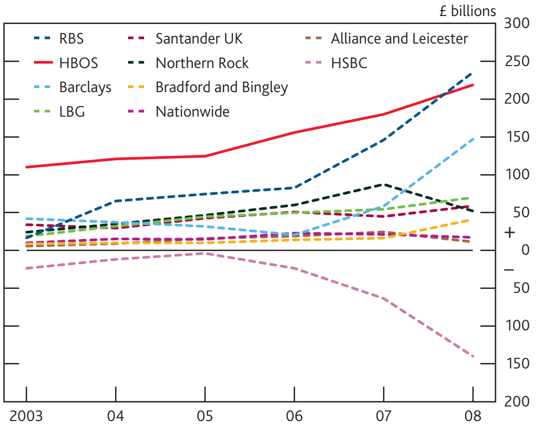
524. As Chart 2.57 shows, the pre-merger firms BoS and Halifax had significantly different loan to deposit ratios: at the end of 2000, BoS had a ratio of 194% whereas Halifax had one of 115%. It was understood at the time that BoS was more structurally reliant on wholesale funding and one of the attractions of the merger with Halifax was its significant deposit base, which would serve to reduce this reliance.[(93)] However, the 2001 combined post-merger ratio of 143% quickly grew to over 160% by 2004 and reached 170% by the end of 2006. Therefore, while the merger between Halifax and BoS did, to a degree, result in the expected medium-term reduction of BoS' reliance on the wholesale market, it also enabled the combined firm to fund in the market from a larger balance sheet (in part facilitated by the securitisation of Halifax's mortgage assets) as the 'wedge' between customer loans and deposits grew (see Chart 2.58).

525. Although they claimed that the loan to deposit ratio was a crude measure and so should not be used to govern its funding strategy, senior management at HBOS did actively review various indicators of relative funding positions[(94)] and understood HBOS to be more heavily reliant on wholesale funding than its peers on that basis.

526. Chart 2.59 shows that HBOS's loan to deposit ratio was well above the ratios of the UK clearing banks and at the top of the range for UK mortgage lenders, with the exception of Northern Rock. This can be partially explained by analysing the composition of HBOS's assets. HBOS (along with the other ex-building societies) had a balance sheet made up of a higher portion of loans and advances (rather than assets associated with investment banking activities) compared with the other large UK banks. At end-2006, loans and advances accounted for 64% of HBOS's balance sheet (compared with, for example, 30% for Barclays and 80% for Bradford & Bingley). According to an HBOS funding strategy paper, the bank believed that, as the UK's largest mortgage provider, it was '*inevitable that we will always have a relatively high customer loans/deposit ratio*'. As shown in Chart 2.59, HBOS's ratio was significantly higher than that of Nationwide, which funded over 80% of its loans with customer deposits throughout the Review Period.

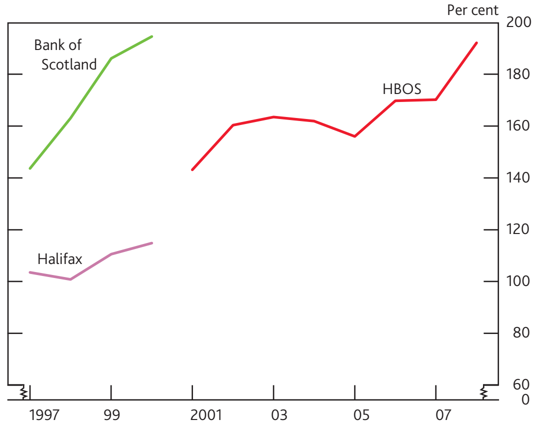
(93) Mr Hornby informed the PCBS that: 'Halifax was the largest UK provider of residential mortgages and liquid savings but lacked any significant presence in Corporate banking or SME banking. Bank of Scotland had significant Corporate banking expertise but lacked the deposit base and capital strength to fulfil its growth potential.'
(94) In Group Funding and Liquidity Strategic Review presented to the Board in May 2007, HBOS had the highest customer funding gap and lowest self-funding ratios of its peers.

Chart 2.56: Major UK banks' customer funding gaps[(a)]



(a) Source: *Annual Reports and Accounts*.

Chart 2.57: HBOS and predecessor firms: loan to customer deposit ratio[(a)]



(a) Source: *Annual Reports and Accounts* and Review calculations.

The structure of HBOS's wholesale funding

527. The term structure and diversification of wholesale funding are important factors in determining the degree of a bank's vulnerability arising from its funding model. If wholesale funding is short-term, banks are more exposed to potential risks arising from the maturity transformation of short-term liabilities into longer-term loans, thereby increasing the risk that liquidity will not be available to meet liabilities in a timely way. If funding is obtained primarily from a single market, the bank is vulnerable to the closure of that market.

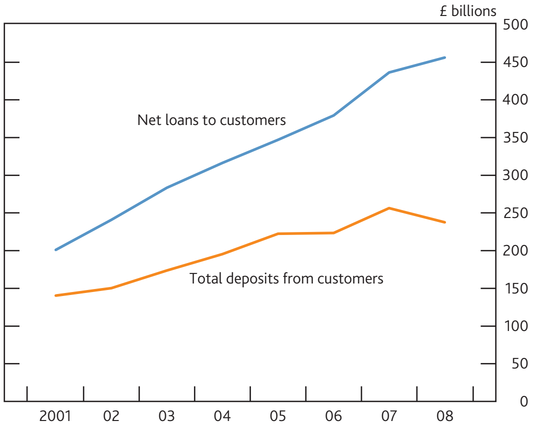
528. HBOS senior management believed that its reliance on wholesale funding made it vulnerable to changes in market sentiment and so took steps from 2004 to 2005 to reduce its reliance on short-term funding and to extend the maturity profile of its wholesale liabilities. As a result, the percentage of funding with a maturity of over one year increased from 33.5% at end-2003 to a peak of 47.5% at end-2006. According to the firm's 2005-2009 funding plan, a tightening in the one-month mismatch limit over 2004/05 had *'driven the increased term issuance seen in previous funding plans'*.

529. The absolute size of its funding requirement meant that HBOS still had large volumes of short-term funding with tenors of one and three months (at their peak in March 2008 of c£64 billion and £61 billion respectively).[(95)] During the financial crisis, rather than allowing the structural funding limits to bite, HBOS adjusted them, typically arguing that this was necessary given market conditions (for example, by August 2008, the Group one-month limit had been increased in absolute terms from £50 billion to £75 billion – a 50% increase).

530. Senior management took measures to diversify the sources of wholesale funding, taking advantage of the expanding funding sources made available as markets deepened and new ones emerged. Although Chart 2.60 shows a wide spread of funding sources there were some areas of concentration, for example, securitisation provided 20% of HBOS's wholesale funding in June 2007 (although there is a benefit from this longer term funding matching more closely the term of assets in the mortgage book). There was a high proportion of unsecured borrowings from the money markets (deposits, CDs and commercial paper (CP)).

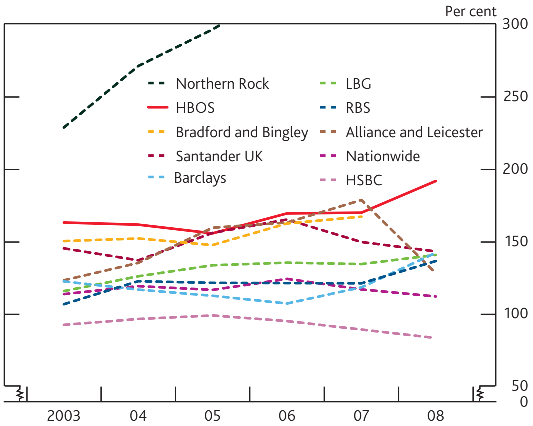
(95) That said, firms with different business models were running positions with much larger volumes of short-term funding. Regulatory reporting data indicate that other firms had to refinance one week positions significantly greater than HBOS's one month position.

Chart 2.58: HBOS customer loans and deposits[(a)]



(a) Source: *Annual Reports and Accounts.*

Chart 2.59: Major UK banks' loan to deposit ratios[(a)]



(a) Source: *Annual Reports and Accounts* and Review calculations.

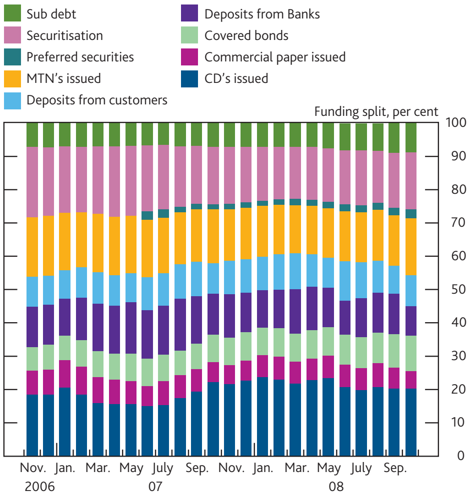
531. From 2003, HBOS became the largest participant among UK banks in the UK Residential Mortgage Backed Securities (RMBS) market. It was also securitising assets in the Netherlands and Australia, and in all major currencies (including US dollar). The firm had built a reliance on securitisation as a source of funding which meant that, when uncertainty grew regarding the credit quality in the underlying assets of these securities, HBOS's funding capacity was restricted.

532. According to HBOS policy, currency limits were set, and funding was diversified across three main currencies (sterling, euro and US dollar). As shown in Chart 2.61, HBOS used US dollar funding extensively (accounting for 30-40% of total wholesale funding) although it did not have any substantial business activity in that currency. Indeed, the purpose of the branch set up in New York in 2004 was to raise wholesale funding to repatriate to the United Kingdom.

533. While there are many benefits that may accrue from geographical diversity in funding, this is not without risk. For example, locked-up collateral, fragile relationships which could be strained in stress, local regulatory requirements etc. are all additional risks that need to be managed. These risks were not referred to in the Funding Plans although Mr Mike Ellis, the Group Finance Director (GFD), stated in representations that HBOS was '*well aware*' of them. These risks crystallised during the crisis – in particular local regulatory requirements applying to US money market funds and an expressed preference for domestic relationships by those counterparties meant that a key source of funding dried up when it was needed most.[(96)]

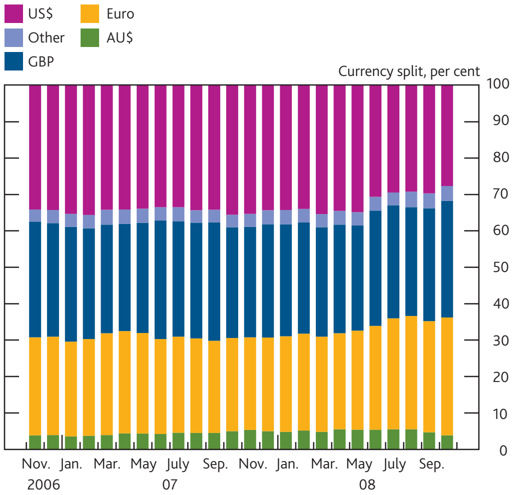
(96) The Funding Plans also failed to address currency hedging strategy but, as currency risk is not a key factor in the failure of HBOS, the subject is not addressed further here.

Chart 2.60: Wholesale funding split by instrument type(a)



(a) Source: HBOS management information.

Chart 2.61: Currency profile of wholesale funding(a)



(a) Source: HBOS management information.

534. Mr Crosby told the PCBS that reliance on wholesale funding proved to be the firm's greatest vulnerability. However, before the crisis, it appears that senior management at HBOS perceived the main risk arising from their funding model to be reduced profitability. From 2006 onwards, it appears that funding capacity was becoming a potential constraint on the business, as Treasury not only tried to meet the planned requirements of the business plans but also above plan business growth: for example, demand for wholesale funding had increased to £13 billion above plan by June 2006.(97)

535. This was judged to be increasingly unsustainable and concerns were raised at the Group Funding and Liquidity Committee: '*The 2007-2011 Funding Plan represents one of our top risks…we have limited contingent capacity to cover a larger funding requirement without causing a re-rating or re-pricing of our credit*'. One of the main constraints on funding capacity was that the firm was not generating a sufficient amount of net mortgage assets to securitise and was approaching the point: '*whereby new business origination will only be sufficient to support enough new issuance to replace maturing securitisations*'. As the growth in the mortgage book declined, new balance sheet growth was in areas with poorer self-funding ratios and which generated assets that were less easily securitised.(98)

536. A further constraint on funding capacity was the firm's one-month wholesale funding limit, which prudently prevented it from further tapping into the available (and cheaper) short-term markets: '*Arguably one of the competitive advantages our peer group has had over us in recent years has been their willingness to run with a higher level of short term funding because of their lower total reliance on wholesale funding*'.(99)

(97) The 2 July 2007 Group Treasury paper, 'Themed Review of Asset and Liability Management', noted that: '*the accuracy of our planning is sub-optimal for funding purposes…The reason why it is less appropriate for funding purpose than for income forecasting is that for funding we tend to look towards the back three years of the plan.. It is clear that far more effort goes into forecasting the early years of the plan than the later years. … The reason why we concentrate on the later years of the plan goes back to capacity planning. … If the projected funding requirement is volatile, even if it is the projected funding requirement three to five years away, it is impossible for Treasury to optimise funding or even to guarantee that the level of funding required will be available…This issue will only be rectified if we improve our planning process and, in particular, become more accurate around the far end of the plan*'.
(98) Self-funding ratios, defined as customer deposits and funding raised from securitisation as a proportion of assets, were 79% for Retail, 47% for Corporate, 43% for Ireland and 57% for Australia in Nov 2006.
(99) GFLC July 2007 – Q2 funding plan.

2

2.8.3 Asset-backed commercial paper (ABCP) conduits: Grampian and Landale

Box 2.4: ABCP conduits

An ABCP conduit (or program) issues commercial paper, a form of short-term debt, in order to finance longer-term liabilities. They first appeared in the mid-1980s and were initially used by commercial banks as a means of financing the trade receivables of corporate customers.

The market grew significantly over the next 30 years; Fitch, the rating agency, estimated the total value of ABCP in issue at end-July 2007 at $1.15 trillion. Different types of ABCP program also developed, the main variants being:

- single-seller – finances the assets of only one originator;
- multi-seller – purchases assets from multiple firms;
- securities arbitrage conduits seek to benefit from the difference between short-term funding costs and (usually highly-rated) longer-term asset returns – in some cases these programs may also historically have delivered a regulatory capital benefit by allowing a bank to hold assets off-balance sheet;
- structured investment vehicles (SIVs) also invest in highly-rated securities but issue medium term notes as well as commercial paper. Investors obtain protection from credit losses (typically 6%-10%) by the issuance of subordinated capital notes.

The sponsor of an ABCP conduit is typically a financial institution and has two roles: to manage the assets; and provide liquidity. The latter arrangements can take several different forms: they will typically cover 'roll-over' risk, the risk that a conduit cannot finance maturing commercial paper; they may cover the credit risk of the assets financed by the conduit; and they can be full or partial. A conduit may not be able to re-finance because of a deterioration of conduit asset values. In that case, the sponsor has to assume the losses from lower asset values, because under the guarantee a sponsor is required to repurchase assets at par. In exchange for assuming this risk, the sponsor receives the conduit profits.

537. At 31 December 2007, Grampian, a securities arbitrage conduit with assets of £18.6 billion, was the largest ABCP programme in Europe.(100) The second vehicle, Landale, was much smaller and a multi-seller conduit with HBOS originated assets of £0.6 billion.(101)

538. According to HBOS, '*Grampian, created in 2002 … is essentially a wholly owned vehicle that arbitraged between the yield on medium/long term investment grade paper and the cost of financing it in the short term Asset Backed Commercial Paper (ABCP) market. As the market grew (to excess) the size of our programme grew. It rose steadily from £9 billion in 2002 to its peak last year* [ie 2007] *of £19 billion. Capital treatment was favourable and Rating Agencies accommodating and it was seen as easy money – and low risk. The programme operated against asset class limits and portfolio rating limits. For example, US RMBS rated AAA to BBB- not to exceed 40% of total portfolio. 100% of the portfolio had to be Investment Grade (AAA to BBB-) with no more than 15% AA+ to BBB-, no more than 10% to be A+ to BBB-, and no more than 2.5% to be BBB+ to BBB-*'.

(100) In a securities arbitrage conduit the aim of the financial sponsor is to issue ABCP as a way to receive funds to purchase term securities. In this way the sponsor earns a spread on the rate they pay to purchasers of the ABCP (lower) and the return they receive on the term securities they have purchased (higher).
(101) With a multi-seller conduit the asset-backed securities that are purchased to be used in the programme are bought from more than one originator. A multi-seller conduit provides more originator diversification and is potentially less risky.

539. Although the assets and liabilities of Grampian and Landale were included in HBOS's balance sheet for financial reporting purposes, they were assumed to be self-funding and so did not feature in pre-crisis internal wholesale cash flow ladders.

2.8.4 The liquidity portfolio: an insurance policy against times of stress?

540. The primary purpose of the liquidity portfolios was to maintain an acceptable (in terms of quality and term) stock of liquid assets that could be used to meet funding outflows in normal and stressed conditions. This relied on the existence of a deep, mature and low volatility market and therefore robust valuations and reasonable haircuts.(102) The Treasury liquid assets portfolio was managed in three segments:

- *Primary:* highly liquid assets that satisfied the FSA's sterling stock requirements. During the Review Period, HBOS was subject to the Sterling Stock Liquidity Regime (SSLR), which required the firm to hold a minimum amount of UK gilts (intended to cover one week of wholesale outflows plus a relatively modest retail outflow). From the information available, it appears that HBOS was using borrowed gilts for SSLR purposes rather than holding them outright.(103)

- *Secondary:* the secondary portfolios were designed with a focus on yield as well as contingent liquidity. Their main characteristics were:

  – they contained no gilts, and other assets labelled 'primary' made up only 0.1% of the total;

  – over 50% of the assets in the secondary portfolios were structured finance products (e.g. ABS, CLOs, and CBOs). These structured finance assets were similar to those held by the ABCP conduits and were also structurally and functionally similar to the structured products HBOS used as a significant source of funding (i.e. securitisation); and

  – approximately 37% of the structured assets in the secondary portfolios had underlying assets in property, meaning that HBOS was exposed to the same sectoral concentration risks in its liquidity buffer as it faced in its lending activity.

541. The majority of the secondary liquidity portfolio was not at the time eligible for Bank of England market operations, although significant quantities of HBOS Treasury assets were in principle admissible under the US Federal Reserve Bank and European Central Bank liquidity schemes.

2.8.5 Key events and triggers: what were the events which triggered the liquidity crisis leading to the firm's failure?

542. This section considers the confluence of events which eventually led to the liquidity crisis that overwhelmed HBOS. The weaknesses outlined earlier made HBOS particularly vulnerable to the events that transpired in late 2007 and 2008.

543. On 14 September 2007, in the face of market dislocations in the provision of funding to ABCP conduits, HBOS invoked its contingency plan. The plan covered early warning indicators,

(102) The 'haircut' is the difference between the market value of an asset used as loan collateral and the amount of the loan. Its size reflects the lender's perceived risk of loss from the asset falling in value.
(103) This was not a breach of FSA liquidity policy at the time and may have attracted some capital benefits. However the term profile of gilts obtained by securities financing transactions and the callability of those trades – which may be linked to the quality of the collateral posted – means they are not as effective as gilts held outright. In interviews conducted as part of the Review HBOS explained that this stock borrowing was conducted using cash and so was risk neutral. HBOS also explained that reverse repo was undertaken to maintain a presence in the market at low or no cost.

management escalation and actions to be taken. It also made provision for action and escalation in the event that a liquidity crisis meant the firm was unable to make payments as they fell due because of operational actions.[104] Although the conduits had experienced funding problems, following the collapse of Northern Rock the firm experienced something of a 'flight to quality', attracting £5.5 billion of additional retail and £2.4 billion of corporate deposits in the final quarter of 2007.

544. Notwithstanding the invocation of its contingency plan, HBOS's balance sheet continued to grow between August 2007 and June 2008 (from £523 billion to £593 billion). This was largely a result of the Corporate Division continuing to sanction new or extended lending as well as honouring existing commitments (See Section 2.4.3).

545. At the start of the financial crisis, concerns about the underlying asset quality of structured finance products affected HBOS in a number of ways: the firm had to provide liquidity to its ABCP conduits; it could no longer tap the securitisation market for wholesale funding; and investors were concerned about the firm's holdings of ABS. As explained in the remainder of this section, the confluence of events during 2008 resulted in HBOS losing an important source of wholesale funding at a time of a major liquidity draw. The impact of the market conditions on HBOS was exacerbated by the firm's concentration of exposure to property-based transactions on both sides of the balance sheet. This meant that the liquidity portfolio, notwithstanding its long term credit performance[105], was unable to function as a source of liquidity when it was needed.

Grampian: an unexpected drain on liquidity

546. Concerns over the asset quality of some ABCP conduits in the summer of 2007 resulted in investors withdrawing funding from some of these vehicles. In some cases, when the conduits looked to the sponsor to provide liquidity through the committed liquidity facilities, funds were not available.[106] The inability of some sponsors to provide liquidity in turn led to a temporary closure of the CP market to these special purpose vehicles and a longer term dislocation.

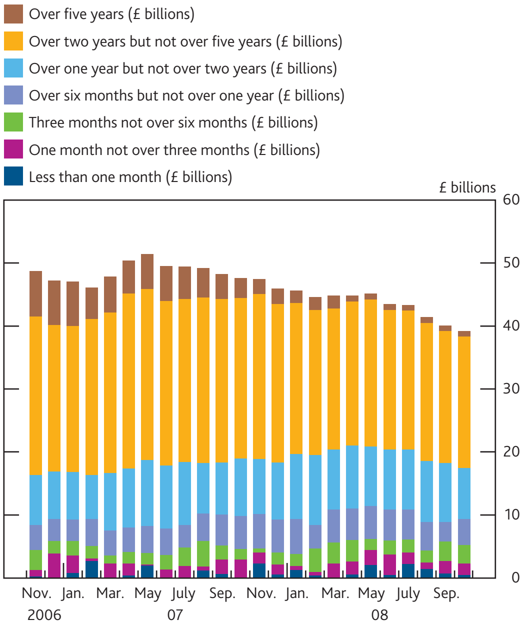
547. In light of the market conditions, HBOS acted promptly to seek to restore confidence and made an RNS[107] announcement on 21 August 2007 stating that Grampian would use the liquidity facilities provided by the sponsor, sufficient to replace the whole of the ABCP outstanding, until market pricing of funding returned to an acceptable level.

548. In a letter to investors also on 21 August 2007, HBOS sought to provide confidence by highlighting the fact that 99.9% of Grampian assets were rated AAA by Moody's/100% by S&P. The 2007 *Annual Report and Accounts* also highlighted that Grampian had £76 million of sub-prime ABS (of the firm's total of £105 million) and £3.7 billion of Alt-A[108] (compared with £7.1 billion for HBOS as a whole).

549. By the end of 2007, HBOS had provided liquidity of £8.1 billion to the two conduits (equivalent to 42% of the vehicles' assets). Having temporarily funded Grampian in 2007 through the liquidity facility, repaid by the conduit by January 2008, HBOS replaced this with a repo facility in February 2008. This enabled HBOS to lend to Grampian on a secured basis and then to use the collateral obtained to raise secured funding in its own name.

(104) The Contingency Plan also states that short term operational action to address immediate liquidity problems are considered and rehearsed by the Group Asset and Liability Committee (GALM) as part of the Stress Testing Framework. A strategic review of funding should also take place.
(105) See 2.7 Asset quality – Treasury Division.
(106) This appeared to have started with IKB's conduit, Rhineland Funding, before spreading to some French and Canadian institutions.
(107) The Regulatory News Service (RNS) transmits company information that is required to be disclosed under market transparency rules.
(108) Alt-A securities are securitisation notes, the credit quality of whose underlying mortgages is between 'prime' and 'sub-prime', a category sometimes described as 'near prime'.

Chart 2.62: HBOS securitisation by residual maturity[a]



(a) Source: HBOS management information.

550. However, the market for funding for ABCP conduits continued to deteriorate and by the end of 2008 the HBOS 2008 *Annual Report and Accounts* showed that the firm had provided £20.4 billion (91% of assets) of liquidity to the two conduits (Grampian had £21.7 billion of assets and Landale £0.7 billion). Further, asset quality had deteriorated significantly, with only 75.9% of assets in Grampian having an AAA rating.

551. As Mr Colin Matthew (the Chief Executive of Strategy, International and Treasury and Asset Management, to whom Treasury reported from mid-2007) commented in the summer of 2008: '*there is no doubt that we allowed Grampian to grow too large, fuelled by market appetite and compounded this by buying Alt-A in the US – again in my view principally yield driven.... And in downside analysis we failed to model what could happen if confidence flowed out of the ABCP market (for it was a bull market model). Geographic diversification while correct as a principle was not fully thought through. And quite simply Alt-A as a class below Prime should not have been so heavily invested in ... it was clear that in anything other than bull markets this was an accident waiting to happen. There were clearly errors made around the size of Grampian ... I have heard it said that it provided funding diversification. It did no such thing, it was purely a yield arbitrage for profit motive.*'

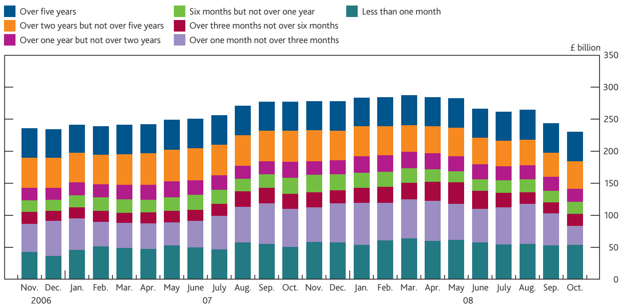
Securitisation

552. HBOS securitisation notes outstanding in June 2007 were £49.5 billion. The firm's planned issuance from securitisation was generally in the range of £10 billion – £12 billion per annum; the 2008 Funding Plan called for £15.3 billion of securitisation funding. The securitisation markets were effectively closed throughout 2008. HBOS was able to issue one securitisation in 2008, but only for £500 million and at a spread much higher than previous issuance (80bps compared with 10bps previously),[109] leaving a funding gap of £14.8 billion from securitisation in 2008. Chart 2.62 shows how the closure of the securitisation market prevented HBOS from replacing maturing notes, thus leading to deterioration in the maturity profile as outstanding notes declined to £40 billion by September 2008.

(109) This increased price might be more indicative of the effective closure of the market rather than investor concerns specific to HBOS.

2

Chart 2.63: Maturity profile of wholesale funding(a)



(a) Source: HBOS management information.

Other wholesale funding

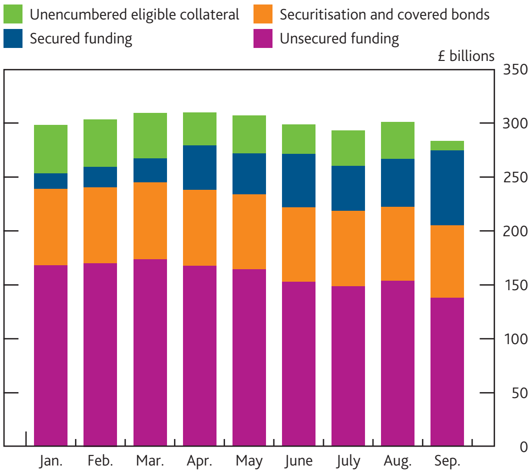
553. In the early months of the financial crisis HBOS increased its reliance on dollar CDs, where there was a growing concentration (the balance grew from £17 billion in July 2007 to over £39 billion at the end of January 2008), switching from the dollar medium-term notes (MTN) programme where costs were increasing. Indeed, the Board was asked to increase the limit on the US dollar denominated (or 'Yankee') CD programme to $100 billion from $75 billion in April 2008. This appears to have been partly driven by the need to replace funding for Grampian.(110) However, a proportion of these CDs was in the form of extendible notes, which gave investors (US money market funds) the option to extend the instrument beyond the scheduled maturity date of thirteen months.(111) Until 2007, almost all of these instruments had been extended. The increase in the use of these instruments after the collapse of Northern Rock left HBOS exposed to a refinancing risk thirteen months later (mainly after the point of failure, as it turned out) and was noted in the calls with analysts in February 2008.(112)

554. In March 2008, there were rumours that HBOS was having difficulty funding (denied in a press release by the FSA). As a consequence, it sustained an outflow of retail and corporate deposits. Although the origin of the rumours is unclear, the incident highlighted further the high degree of uncertainty in the UK banking sector at that time and HBOS's apparent vulnerability to market gossip. Whatever the nature of the concern, there was a marked change in market perception of HBOS's strength compared with peers from March 2008 onwards: credit default swap (CDS) spreads widened and remained higher than peers. In early April, the Group FD of HBOS reported to the Board that CDS levels for HBOS had '*worsened over the period in both absolute terms and relative to our peer group … we remain at relatively higher levels than we would like*'.

555. As Chart 2.63 demonstrates, there was a gradual deterioration in the maturity profile of the firm's funding from this point onwards, as maturing longer term funding was not replaced. Nevertheless, it appears that there was an apprehension to 'pay up' for what HBOS perceived to be over-priced longer term funding, even when it was available, to avoid the markets interpreting it as a distress signal. As the funding position worsened, the firm revised its funding plans, seeking to grow its customer deposit base. This strategy was ill-timed: growth in customer deposits takes time to materialise (and competition between firms was increasing) while reduced wholesale funding capacity took place relatively quickly.

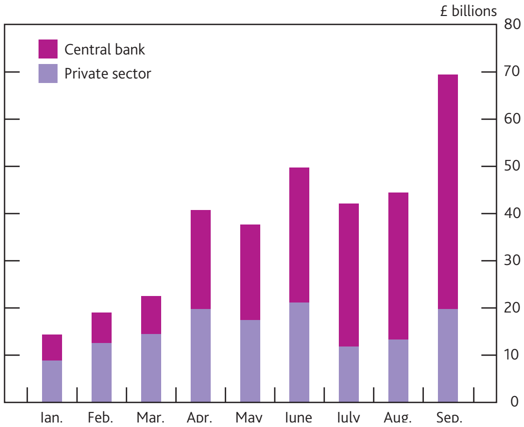
(110) US markets were still content to fund HBOS, the sponsor of the conduit, at a time when they had backed away from the latter.
(111) In the case of HBOS, the notes were typically for five years, but with an option to give three month notice after the initial ten-month period.
(112) Although it is difficult to confirm the extent of use of extendible notes from the data, there is a roll down of dollar CDs with a residual maturity of over one-year maturity post Northern Rock.

Chart 2.64: Wholesale funding and unencumbered collateral(a)



(a) Source: HBOS management information and FSA regulatory data.

Chart 2.65: Private sector and central bank repo funding(a)



(a) Source: HBOS management information.

556. As unsecured wholesale markets became increasingly difficult for the firm and the securitisation and covered bond markets remained closed, HBOS began to replace these sources with secured repo (sale and repurchase transaction) funding: see Chart 2.64.

557. HBOS initially traded with the private sector via repo but over the spring and summer of 2008 it transacted in increasing amounts through central bank facilities.(113) As Chart 2.65 shows, central bank funding grew from £5.4 billion in January 2008 to over £30 billion at the end of August and almost £50 billion immediately before the firm sought ELA.

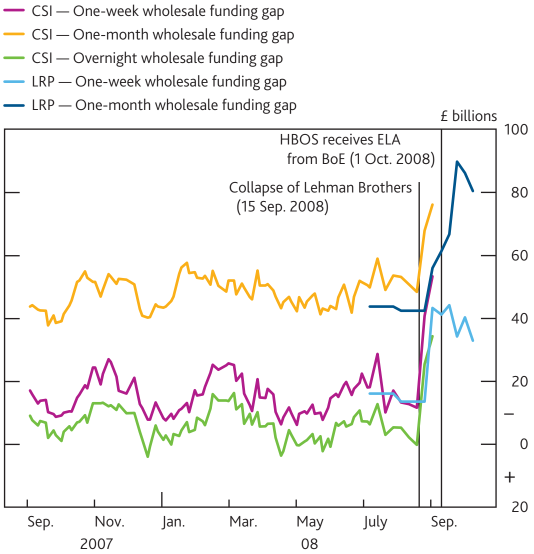
558. HBOS did not consider (secured) repo funding to be a '*business as usual*' source of funding pre-crisis. According to Mr Ellis, the intention was for the firm to use repo transactions during the crisis, employing collateral from its secondary liquidity portfolio as well as other assets, to reduce its short-term funding position and to manage internal limits and triggers. The firm's main liquidity management target, the all currency one month mismatch liquidity ratio(114), was now under pressure. In November 2007, the Group Funding and Liquidity Committee (GFLC) agreed a relaxation from -5% to -10%, 'responding to the immediate pressure on ratios' as a result of increased volatility in the financial markets, but there were four breaches of the revised limit in April 2008. The increased use of repo funding was the firm's only means of maintaining this limit.

559. A significant source of this secured finance was the Special Liquidity Scheme (SLS), launched by the Bank of England on 21 April 2008. It enabled UK banks to access funding following the closure of the ABS market, by receiving UK Government Treasury bills in exchange for legacy assets.(115) It meant that banks could still issue securitisations of their own mortgage and credit card pools to use as collateral in the SLS. HBOS used this facility from the first month it was established and, by 30 September 2008, it was the firm's primary source of new secured funding, having posted a total of £41.5 billion of RMBS and covered bonds in order to obtain £28.4 billion of funding (at least £25 billion of which was securitised in 2008 Q3).(116)

(113) HBOS had access to central bank facilities in the United States, Australia and through the European Central Bank, as well as in the United Kingdom.
(114) Defined as the net wholesale cash flow over one month as a percentage of wholesale funding liabilities.
(115) Aaa rated UK and EEA RMBS, and Aaa rated UK, US and EEA credit card ABS (including 'own' originated transactions). Other Aaa collateral such as covered bonds, government agency and US GSE paper was also eligible, as were Aa3 or higher rated G10 government debt. Other securitisations, such as CMBS, CLOs, and US RMBS (or securitisations rated Aa1 or lower) were not eligible.
(116) It should be noted that HBOS was proactive in utilising its securitisation capability to manufacture and deliver over £40 billion of AAA rated securities (all of which would have been eligible collateral for SLS purposes). This demonstrates that HBOS's securitisation function was a 'well oiled' machine.

2

Chart 2.66: HBOS's wholesale funding gap[a]



(a) Source: FSA liquidity monitoring data.

560. In June 2008, HBOS's Chairman and CEO told the FSA that if wholesale funding stopped abruptly, the firm had no contingency '*other than resort to HMG*' which they believed was the case for almost all banks. Lord Stevenson's opinion was that the SLS had not achieved the Governor's ambition of taking liquidity issues off the table.

The final month: September 2008

561. By the time that Lehman Brothers collapsed on 15 September 2008, HBOS had no real options left, having already used a significant proportion of its eligible collateral (see Chart 2.64). In the following days, it came under acute and sustained funding pressure. Although the firm continued to fund in the unsecured wholesale market, it was typically on an overnight basis; it also received – and in some cases acceded to – requests to buy back debt instruments before maturity.

562. Furthermore, HBOS began to see material outflows of customer deposits. The Irish and Australian businesses were also experiencing customer withdrawals and so required additional funding from the United Kingdom to meet local regulatory requirements. As a result of these factors, HBOS faced an additional, unexpected funding need of £12.5 billion in the week after Lehman Brothers failed.

563. It is unclear what impact the 18 September 2008 announcement of the recommended offer by Lloyds TSB had on HBOS's funding position. There was a view among management that some institutions reduced their individual limits to a lower combined limit (with the reduction biting for HBOS not Lloyds TSB), thus reducing HBOS's borrowing capacity.

564. On 19 September, the OCC[117] restricted the repatriation of funds to the United Kingdom. The immediate effect of this was that HBOS could not access \$2.5 billion that it had intended to use to meet maturing liabilities in London.

(117) The US Office of the Comptroller of the Currency, which supervised HBOS's US bank branch.

565. Overall, the firm's liquidity position deteriorated dramatically in the second half of September 2008, as shown in Chart 2.66. HBOS did not meet the regulatory SSLR standard on 17 September and its internal one-month and eight-day mismatch limits on 19 and 22 September respectively. The position continued to deteriorate: further deposit outflows resulted in an additional £2 billion funding need over the last week of September; and increasing volumes of overnight funding meant that daily wholesale maturities were between £15 billion and £20 billion. The firm had exhausted its eligible collateral for use in the SLS and the Tripartite authorities decided there was no alternative:(118)

> *'An alternative to providing institution-specific ELA for HBOS and RBS might have been to extend additional liquidity to these banks through the SLS. There were essentially two difficulties in doing so. First, the SLS was a market-wide facility designed to provide liquid assets (Treasury bills) in exchange for illiquid assets to the banking system as a whole for an extended term (3 years). Short-term liquidity to meet the emergency needs of two individual banks did not sit well with this purpose, particularly as the scale of liquidity support needed by the two banks would have given the Bank an excessively concentrated exposure to them under the SLS. Second, neither HBOS nor RBS had eligible collateral available in sufficient quantities to draw the quantity of liquidity that they required from the SLS. HBOS had mortgages that would be eligible if securitised, but had not had time to complete the securitisation process (as noted above, these assets were securitised over the last quarter of 2008 and subsequently used in the SLS).*
>
> *To amend the SLS to accept a wider range of collateral, including unsecuritised loans, would have risked distorting the purpose and design of the scheme by adapting it to encompass the specific needs of two individual banks. Extending collateral eligibility in the SLS would have entailed announcing the changed criteria publicly and allowing all banks access on those criteria. In these circumstances, choosing to extend ELA on terms tailored to the specific situation of the two banks, rather than adapt the terms of the SLS, was an appropriate decision.'*

2.8.6 The Basel III liquidity regime: would it have reduced the liquidity risk?

566. Deficiencies in the FSA's liquidity regime in place before the crisis can be demonstrated by analysing retrospectively how HBOS's liquidity position would have appeared at end-August 2008, had it been calculated on one of the new Basel III liquidity standards, the Liquidity Coverage Ratio (LCR).(119)

567. Basel III was obviously not in force during the Review Period and there is therefore inevitably an element of speculation as to what the position might have been had Basel III been in force at the time. However, we are using Basel III for two reasons: in part to test and assess the current regime; and to provide the context to enable a limited comparison to be drawn as to how regulators and market participants would view HBOS by today's standards.

568. Inevitably, a number of assumptions were made in developing a proxy Basel III LCR for HBOS. The analysis showed that if the new Basel III LCR standard had been in force at the end of August 2008, although HBOS would have been the second strongest of the largest UK banks(120),(121), it would have had to increase its stock of high-quality unencumbered liquid assets by £70 billion to £113 billion.

(118) *Review of the Bank of England's Provision of Emergency Liquidity Assistance in 2008–09*, October 2012, Report by Ian Plenderleith.
(119) Given data availability, it has only been possible to calculate the LCR for this one month in 2008.
(120) This ratio would have been flattered by the T-bills obtained through the SLS.
(121) The Prudential Regulation Authority's regime inherited from the FSA would have shown a similar picture.

569. It seems likely that HBOS would not have been prepared to carry the level of liquid assets implied by the LCR, had it been in place throughout the Review Period. The firm would probably therefore have reduced its reliance on wholesale funding with a maturity of up to one month. The other Basel liquidity measure, the Net Stable Funding Ratio (NSFR) would have put a lower bound on the proportion of funding with a maturity of over one year and so the balance between short and medium term funding might also have been more conservative. In combination, these measures should have made HBOS more resilient to the funding problems that started to materialise from the autumn of 2007, though it is impossible to say to what extent. Ultimately, however, this would only have bought the firm time, given the credit losses that subsequently emerged.

2

2.9 Capital

2.9.1 Introduction

570. HBOS had insufficient loss absorbing capital (£13.5 billion under a Basel III estimate) as at 31 December 2007 to cover the reported losses between 2008 and 2011 (£26 billion[122]). These losses would have made the Group insolvent without the capital injections by the UK Government and LBG (see Section 2.9.6). The purpose of this section is to consider why HBOS's capital position proved insufficient to absorb the losses.

571. This section focuses on:

- HBOS's capital position during the Review Period: considering the firm's overall capital strategy (Section 2.9.2); its actual capital position (Section 2.9.3); and the composition of capital resources (Section 2.9.4);
- the prevailing regulatory framework for capital during the Review Period (Section 2.9.5);
- the impact on capital of the firm's reported performance in the period 2008 to 2011: did the firm have sufficient capital to withstand the financial crisis that occurred in that period? (Section 2.9.6); and
- an estimate of what the firm's capital position would have looked like had Basel III been in place (Section 2.9.7).

572. The firm's implementation of Basel II, including the use of models and development of the Internal Capital Adequacy Assessment Process (ICAAP), is considered within Part 4, Section 4.6, '*Supervisory approach to capital and Basel II implementation*'.

2.9.2 The firm's overall capital strategy and philosophy

573. Although HBOS's approach to capital management does not appear to have been out of line with the prevailing approach among banks at that time, subsequent events have demonstrated both that the prevailing approach was inadequate, and that HBOS failed to appreciate the specific risks in its business that differentiated it from peers and warranted holding more capital.[123]

574. Capital discipline was a key stated element of HBOS's strategy, and its intended approach was to maintain a strong capital position, as set out in the 2007 *Annual Report and Accounts*: *'It is HBOS' policy to maintain a strong capital base to support the development of its business and to meet regulatory capital requirements at all times. HBOS recognises the impact on shareholder returns of the level of equity capital employed and seeks to maintain a prudent balance between the advantages and flexibility afforded by a strong capital position and the higher returns on equity possible with greater leverage.'*

(122) This is after payment of dividends in 2008 and 2009.
(123) See Sections 2.4.9, '*Loan impairment losses in Corporate*' and 2.9.3, '*The firm's actual capital position*'.

2

575. At a quantitative level, this translated into various target capital ratios, albeit with flexibility to move within 25 basis points either side. The targeted ratios included:

- regulatory Tier 1 and Total Capital ratios of 8% and 12% respectively;(124)
- various internal ratios: including; a banking Tier 1 ratio (7%);(125) an equity backing ratio (5.75%);(126) a banking equity ratio (4.75%);(127) and
- a gearing limit whereby preference shares and preferred securities were less than 25% of Tier 1.(128)

576. These targets were in place for the majority of the Review Period but were modified in late 2007 for the introduction of the Basel II regime, and then strengthened in April 2008, when HBOS raised additional capital. Of these target ratios, the Regulatory Tier 1 and gearing ratios were publicly disclosed to the market.

577. With the introduction of Basel II, the target ranges were increased by 50 basis points to recognise potential greater volatility in the capital calculations and provide greater flexibility in volatile markets, while the Total Capital ratio target was reduced to 11% due to the more stringent measure of available capital resources (e.g. Basel II required the additional deduction of expected losses). For similar reasons, the firm also increased its internal gearing limit to 30% from 25%, although as the Group's projected gearing ratios in its business plan were above 25% for each year this also meant the Group avoided projecting a breach or being constrained by a 25% gearing limit.

578. The reduction of the Total Capital ratio target by HBOS offset the strengthening of the capital regime caused by the change to Basel II. As at December 2007, a reduction of 1% meant around a £3 billion reduction in the capital requirement which marginally exceeded the fall in capital resources of £2.8 billion.

579. At the time of the April 2008 capital raising, the firm increased its target Tier 1 ratio by 0.5% to 8.5% and the Total Capital ratio by 1%, back to 12%, while also introducing a new Core Tier 1 target of between 6% and 7%.

580. The Group's targets were more stringent than the prevailing Basel regulatory standard in terms of the quantum and quality of capital that the firm held. The minimum regulatory standard would have allowed:

- the Regulatory Tier 1 and Total Capital ratios to be as little as 4% and 8% respectively; i.e. 4 percentage points below the firm's target (or about £13 billion less, on the basis of the RWAs as at 31 December 2007); and
- the firm to hold 50% of Tier 1 in preference instruments and 50% of total capital as Tier 2; which would compare to the firm's targets, in which preference instruments were 25% of Tier 1, and Tier 2 was 33% of Total Capital.

581. In addition to the minimum requirement, the FSA required the firm to meet a 9% Total Capital ratio (i.e. a 1% capital add-on to the regulatory minimum, but 3% below HBOS's target) for the majority of the Review Period. See Part 4, Section 4.6, '*Supervisory approach to capital and Basel II implementation*' for more details on the prevailing capital regimes, including weaknesses.

(124) Using the regulatory rules to calculate both the numerator (capital resources) and the denominator (risk weighted assets).
(125) Regulatory Tier 1 capital with a further deduction of 50% of the firm's investment in non-consolidated businesses (i.e. primarily its insurance business).
(126) Broadly accounting shareholders' funds but with certain adjustments (e.g. deduction for goodwill).
(127) As per the equity ratio but with a further deduction of 50% of the firm's investment in non-consolidated businesses.
(128) The denominator for all ratios is the regulatory calculation of Risk Weighted Assets.

582. The Group's target ratios were broadly determined by reference to peers, experience and external influence (e.g. FSA requirements and rating agencies). Generally, the Group's approach to capital management and target ratios was not out of line with peers at the time. Most banks managed themselves to a variety of ratios and had made public similar Tier 1 targets at various times in the Review Period. For example, Barclays disclosed a target Tier 1 ratio of 7.25%; RBS a ratio of 7% to 8%; and HSBC a ratio of 8.25%. Other banks also recognised the trade-off between capital and leverage in promoting shareholder returns and soundness, and made similar comments about the need for a prudent balance to be struck.

583. However, this was in a Basel I world in which it was known that the measure of risk in the ratio was crude and insensitive to changes in risk. Matching peer group ratios was only appropriate to the extent those peers had a similar risk profile. In some respects (e.g. see Section 2.4.9, '*Loan impairment losses in Corporate*') HBOS's risk profile was higher than other UK banks, something the firm did not recognise until too late. It is also not clear that leverage was a consideration in setting target capital ratios, despite it increasing in the period. HBOS's prevailing view appears to have been that it was a low risk business and so needed to hold less capital.

584. Stress testing was a feature of the firm's annual planning cycle. However, the stress tests carried out did not give rise to any perceived need by the firm to hold additional capital to cover a downside recession. A mix of strong underlying profitability and a suite of management actions (that could be taken to mitigate the impact of the stress) were considered sufficient by the firm to deal with the adverse effects of any stress scenario.

585. However, it should be recognised that there are greater challenges in assessing capital requirements for concentrated portfolios. Some of these were exacerbated by HBOS's known weaknesses, such as poor management information, and/or complacency as the benign economic conditions contributed to a sense of low risk. However, the benign economic period and the publicly unrated nature of HBOS's corporate portfolios limited the available historical loss data by which the firm could judge risk.

586. Two main changes were made to the firm's approach to capital management in the Review Period. One was the implementation of Basel II.(129) The other involved separating the stress-testing process from the normal business planning cycle, which was done in 2007. This latter change was intended to increase the focus given to stress testing, which had failed to achieve sufficient prominence within the business, given the priority placed on completing the business plan. It does not appear, however, that the role of stress testing as a capital planning tool was fully appreciated until late 2008. As a September 2008 Board paper noted: '*The role of stress testing can no longer be considered an academic exercise to satisfy the regulator. Understanding the potential downside, adjusting our book to reduce this volatility and ensuring we possess robust mitigants will be vital to successfully managing capital going forward.*'

2.9.3 The firm's actual capital positions

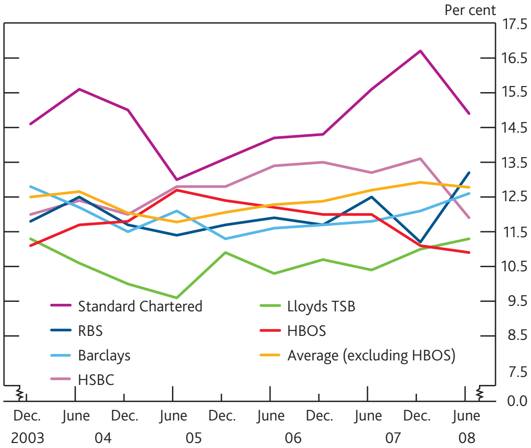
587. From the firm's regulatory reporting, there is no evidence that the firm breached its Individual Capital Ratio (ICR) or Individual Capital Guidance (ICG) during the Review Period.

588. HBOS's reported Tier 1 and Total Capital ratios are shown in Chart 2.25 and Chart 2.67, alongside peers. Under the prevailing regulatory capital regime:

(129) For more detail on Basel II see Part 4, Section 4.6.3, *'Basel II implementation'*.

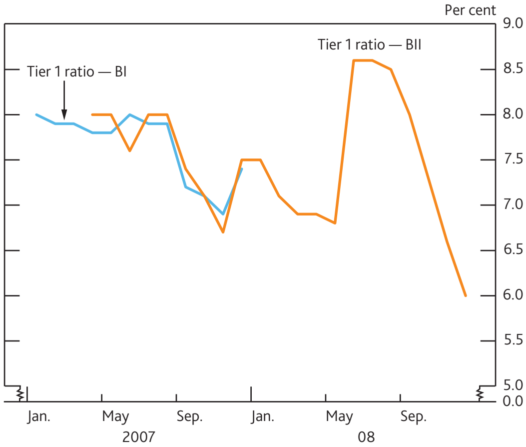
2

Chart 2.67: UK banks' published Total Capital ratios[(a)]



(a) Source: *Annual Reports and Accounts and Interim Results.*

Chart 2.68: Reported Basel I and Basel II ratios, April 2007 to December 2008[(a)]



(a) Source: HBOS Board Management Information and *Annual Reports and Accounts*.

- HBOS's Tier 1 ratio was 7.6% as at December 2003 (below the peer average), before rising to 8.1% and converging with the peers by the end of 2004. From 2005, the ratio was relatively stable at 8% and above the peer average until 2007, when it started to decline.

- The firm's reported total capital ratio exhibited a gradual downward drift from 12.7% in June 2005 to 12% in June 2007.

- HBOS's capital position did not appear to be an outlier coming into the financial crisis. Only from late 2007 did it start to look weak compared to the other major UK banks.[(130)]

589. All the major UK banks comfortably met relevant regulatory requirements going into the financial crisis. Some, such as HBOS, however, turned out to be much more vulnerable to the impact of the crisis, as illustrated by the severe decline in its capital ratios in 2008 (Chart 2.68) and its ultimate failure and recapitalisation.

Evolution of Tier 1 capital ratios from late 2007 to late 2008

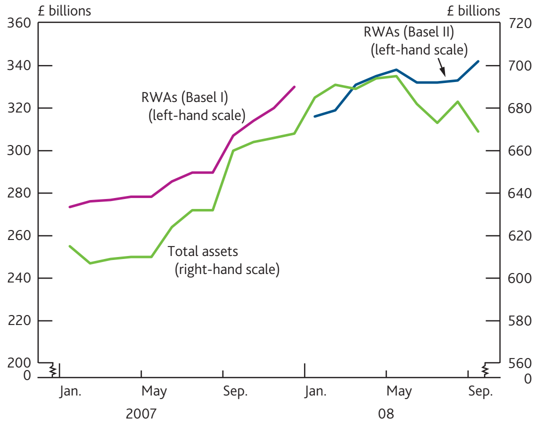
590. Chart 2.68 shows the evolution of the Group's internally reported Tier 1 ratios under Basel I and Basel II over the period January 2007 to September 2008.[(131)] Chart 2.69 shows the Group's assets and RWAs over the same period.

591. During the first half of 2007, the Basel Tier 1 ratio experienced a slight dip before rising back to the Group's 8% target at the half year. Over the remainder of 2007, the Tier 1 ratios were on a downward trend, in the main due to increasing RWAs on the back of continued strong asset growth.

592. It appears that the potential for its capital ratios to fall was first noted by HBOS around August 2007 when a paper to the Group Capital Committee (GCC) projected a possible low 7.67% Tier 1 ratio for the end of 2007. The September 2007 Board MI reported a projected Tier 1 ratio of 7.6% for the end of 2007.[(132)]

(130) RBS's June 2008 ratios benefited from a £12 billion rights issue in June 2008.
(131) The firm stopped reporting Basel I information at the end of 2007. Basel II information was reported in the Board management information from April 2007 and was the basis for the Group's principal Tier 1 target from 1 January 2008.
(132) Reported in the 'Capital Management' section of the Board MI. The 'Key Financials' section, reported earlier in the Board MI, still reported a planned 8% Tier 1 ratio, without highlighting the potential for the ratio to fall below plan.

Chart 2.69: RWAs and total assets January 2007 to September 2008(a)



(a) Source: HBOS Board Management information.

593. Between September and November 2007, the Group had two main concerns affecting its capital ratios:

- the market turmoil and the increased cost of capital issuance; and
- the growth in RWAs, particularly in Corporate, due to reduced churn, outstripping profit growth.

594. At this point, there was recognition by the firm of a reduction in profitability but there appeared to be no expectation of significant losses that would erode its capital. The firm appeared to believe at the time that the markets were experiencing only short-term disruption. As illustrated in the Bank of England's (non-stressed) GDP projections, this would not have been inconsistent with central market expectations. It appears capital was still viewed by the firm as a constraint on asset growth.

595. The annual Group Business Plan 2008 – 2012, approved in November 2007, projected a Basel II ratio of 7.2% for the 2007 year-end, which was below the Group's '*normal operating range*'. However, it appears that this was not considered an immediate threat by the firm, as ratios were projected to be rebuilt over the following couple of years.

596. The main remedial actions proposed by the Group to address its capital ratio were to seek to reduce RWAs by reducing asset growth and, in 2008, by rolling out more Basel II models while changing its approved Basel II models to eliminate what it regarded as FSA-imposed conservatism.

597. There was a small improvement in the ratios at the 2007 year-end as the firm recognised profits of £2.2 billion[133] and benefited from other actions.[134] However. the reported Tier 1 ratio of 7.4% (on a Basel I basis) was outside the Group's target range (7.75% to 8.25%), although on a Basel II basis the ratio was 7.7%,[135] just within the range (7.5% to 8.5%).

(133) Profits are not eligible to be recognised in capital until verified by the firm's auditors and so typically are only recognised in capital when a firm prepares its interim and full year results.
(134) The FSA granted a waiver that permitted venture capital exposures to be risk weighted rather than deducted from capital and permitted the expected loss deduction from capital to be made net of tax. See Part 4, section 4.6.3, '*Basel II implementation*'.
(135) Although as set out in Part 4, Section 4.6.3, *'Basel II implementation'*, the weakness in the firm's modelling approaches meant this number was ultimately unreliable.

598. The decline in the ratios continued in early 2008 as RWA growth continued and profitability declined.

599. Nevertheless, in February 2008 analysts were given guidance that the Tier 1 ratio during 2008 would be within the Group's target range and was considered comfortable: '…*we have set ourselves a target Tier 1 range of 7.5% to 8.5% and expect to operate comfortably within this range and under normal circumstance towards the midpoint of the range*'. The Group also proposed a final dividend for 2007 that represented an 18% increase for the total dividend for year and an increase in the dividend pay-out ratio to 46%.(136)

600. The Group's ability to constrain RWA growth was also not helped by a failure by the firm to understand fully its commitments. Papers to the GCC and the Group Board indicate that there was an approximately £10 billion increase in the Corporate Division's RWAs in March due to additional undrawn commitments being identified. This appears to be due to incomplete or poor data capture in certain of the systems being used.

601. Around March and April 2008, the key risk facing the bank was still considered to be '*funding and liquidity*', rather than '*capital adequacy*'. Nevertheless there was now a perception that the Group needed to take additional measures to strengthen its ratios. The projected Tier 1 ratio for June 2008 was estimated to be 7.2%, below the minimum end of the target range of 7.5% and below the guidance given to analysts in February. This was due to lower than expected profitability in the first half of 2008 and higher RWAs.

602. The ExCo minutes for 22 April 2008 record that: '*The current forecast half year (2008) position with respect to Target Tier 1 Capital was unacceptable…*'; and that the '*Group should not allow itself to be relatively weak in terms of capital*'. Subsequent to this meeting, an ad hoc meeting of ExCo, held on 24 April 2008, agreed to proceed with a recommendation to the Board that the Group should seek to raise additional capital by means of a fully underwritten rights issue.

603. More generally, there had also been a step change in sentiment, both by the market and regulators. The perception of what constituted a strongly capitalised bank had changed, with the focus moving away from Tier 1 capital to core capital better capable of absorbing losses.(137) This was driven by continuing market turmoil and losses on ABS, but also increasing concerns about the state of the UK housing market. The relative positions of firms also became important as weaker firms were subject to greater scrutiny. This was important in determining the direction of any 'flight to quality' by investors.

604. In light of the prevailing conditions, the Group launched a £4 billion rights issue on 29 April 2008, proposed payment of the 2008 interim divided as a scrip issue, and proposed that the final 2008 dividend be reduced to a 40% pay-out ratio. However, the rights issue, which had only a 8.29% take up from HBOS shareholders,(138) proved too little too late to restore or improve investor confidence in the firm (see also Section 2.10, '*Shifting market perceptions of HBOS*').

605. Asset growth was finally halted around mid-2008 and the proceeds of the rights issue significantly improved the ratios in July 2008. This provided only temporary respite as losses continued to be recognised and RWAs continued to grow.(139) The growth in RWAs was in part due to the pro-cyclicality of the Basel II credit risk models.(140) The firm's anticipated reductions

(136) The total dividend for 2007 was 48.9 pence per ordinary share (2006: 41.4 pence).
(137) At this time the FSA introduced a 5% Core Tier 1 target for major UK banks. HBOS was advised on 18 April of this requirement.
(138) The firm still received £4 billion as the transaction was fully underwritten.
(139) By the end of 2008, RWAs had fallen back to £328 billion, but this was primarily due to the disposal of BankWest (at a loss) rather than any reduction in lending.
(140) Pro-cyclicality refers to the potential for models to be correlated with the performance of the economy. As the economy deteriorates the models require firms to hold more capital, potentially reducing their willingness to lend with further implications for the economy.

in RWAs in 2008 due to model roll-outs and other changes did not happen, due to continuing FSA concerns with the models.(141)

606. Reflecting on the challenges to the capital position in September 2008, the firm noted the increased sensitivity of the Basel II methodologies to economic conditions, and that it was particularly exposed relative to peers:

> '…*our business mix and risk profile, including risk concentrations in our credit portfolio,* ***makes HBOS more vulnerable to increased capital requirements under Basel II capital rules to a 1 in 25 year UK downturn than some peers****:* -
>
> – *Business mix – as the UK number 1 mortgage lender we have a greater exposure than peers to a product that is inherently cyclical.*
>
> – *Grade profile – We typically target companies outside the FTSE 350 which tends towards the "BB" market on an external rating scale and hold equity and mezzanine debt. Our major competitors would typically have a greater proportion of major corporates' debt …*
>
> – *Commitments – Basel II has fundamentally changed the dynamics of Corporate undrawn commitments as they require more capital than under Basel I. At current pricing returns are now inadequate on many of these facilities …*
>
> – *Concentrations – we are both UK centric and concentrated in our chosen areas. Much of our concentration is in sectors prone to significant cyclicality.*
>
> *Even after the rights issue* ***a significant recession could have a materially adverse impact on HBOS capital ratios and move us outside the target capital ratio range.***'(142)

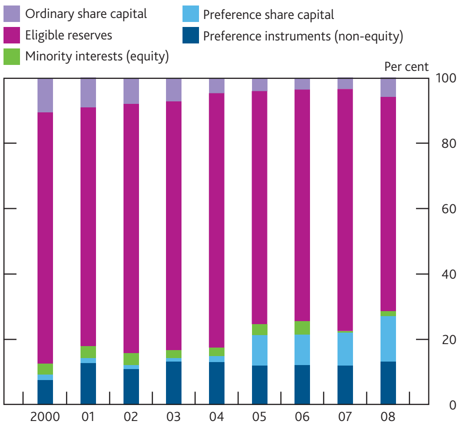
607. The latter part of 2008 saw ever larger losses being reported by HBOS, rapidly eroding the Group's capital base. Pro-cyclicality of the models also continued to affect the firm's RWAs. Over the course of 2008 as a whole, HBOS disclosed that the decline in the economy caused a 10% increase in RWAs for its retail portfolios while the main corporate model experienced a slightly larger rise of around 13%.

608. By the end of 2008, the reported Tier 1 ratio had fallen to 6%, well below the Group's target.(143)

(141) The property lending model was put on a further twelve month parallel run. The firm did, however, achieve a £3 billion reduction in its operational risk weighted assets in January 2008 following a recalibration agreed with the FSA.
(142) HBOS Board paper, September 2008, '*Capital requirements in Basel II*'.
(143) Although the recapitalisation was announced in October 2008, it did not happen until the acquisition of HBOS by Lloyds TSB in January 2009.

2

Chart 2.70: Composition of reported Tier 1 capital(a),(b)



(a) Source: HBOS *Annual Reports and Accounts*.
(b) Excluding goodwill which is a deduction from capital.

2.9.4 The composition of capital resources

609. The highest quality of capital which exhibits the greatest loss absorbing characteristic is common equity (e.g. the proceeds of issuing ordinary shares and retained profits). Other Tier 1 instruments (including innovative instruments) and Tier 2 instruments decrease in loss absorbing quality in that order. HBOS did not have enough high-quality capital to absorb the losses it incurred between 2008 and 2011. The Basel I and Basel II regimes were built on the misunderstanding that the lower tiers of capital instruments could absorb losses in a going concern state short of resolution. This was wrong.

Common equity v preferred securities

610. Since the merger in 2001 there had been a gradual decline in the overall quality of HBOS's Tier 1, as common equity had declined relative to preference shares and preferred securities (see Chart 2.70). There was a noticeable step change in 2005, when under perceived pressure from the market to increase its preference shares relative to core capital, the firm issued around £1.8 billion in preference shares. HBOS was not the only bank to do so at this time.(144)

611. As noted in paragraph 575, the firm had a 25% gearing policy for the majority of the Review Period. With a reported Tier 1 ratio steady at around 8% for the majority of the period, approximately 6% was represented by common equity which was still comfortably above the regulatory minimum.

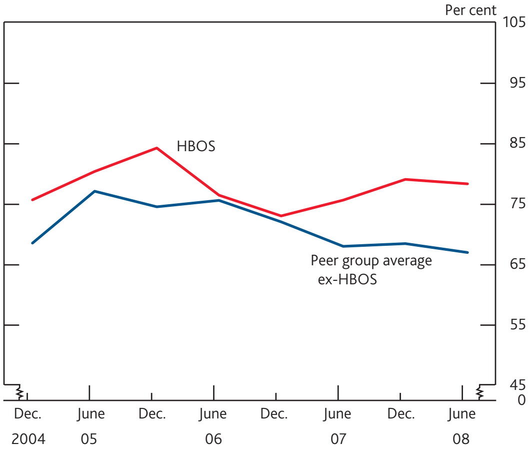
612. This illustrates the short-term outlook of market sentiment. In the benign times in the early part of the Review Period, the pressure on firms was to increase leverage to boost shareholder returns. But as the economy deteriorated, the market focus switched to the quality and quantity of equity.

Tier 1 v Tier 2

613. Chart 2.71 shows Tier 2 as a percentage of Tier 1 capital for HBOS and its peers. Although the firm was always above the average in its use of Tier 2 capital, this does not mean that the firm was an outlier in relying on lower quality Tier 2 coming into the crisis. From 2007 the position worsened, in part as the firm pulled its planned Tier 1 issuance in the second half of 2007 on the grounds of increased cost and a fear that to be seen paying those costs would affect investor confidence in the firm.

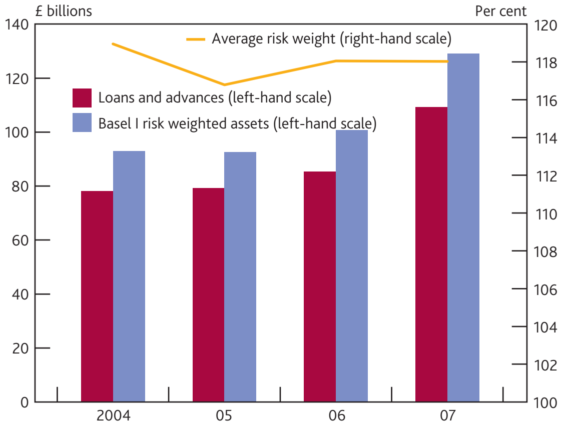
(144) Barclays also announced a change in the mix of its Tier 1 in 2005 by introducing more preference shares.

Chart 2.71: Tier 2 as a percentage of Tier 1 capital(a)



(a) Source: firms' regulatory reporting and Review calculations.

Chart 2.72: Loans and advances (drawn balances), Basel I risk weighted assets and an average risk weight for Corporate Division(a),(b)



(a) Source: HBOS *Annual Reports and Accounts* and Review calculations.
(b) The average risk weight is calculated as RWAs divided by loans and advances.

2.9.5 The determination of capital requirements

614. For the majority of the Review Period, the underlying global capital framework was governed by Basel I, which was replaced in 2008 by Basel II. Part 4, Section 4.6, '*Supervisory approach to capital and Basel II implementation*', describes the Basel regimes and the Group's transition between them.

615. As set out in *The RBS Report* and *The Turner Review*, there was a general failure in the global regulatory framework to require firms to hold sufficient capital in terms of both quantity and quality.

616. While this Report does not detail these general failings, it is worth noting the weakness of the Basel I regime and its impact on HBOS. Chart 2.72 shows the reported RWAs and loans and advances of the Corporate Division between 2004 and 2007. The RWAs have been divided by the loans to derive an average risk weight for the division. This average risk weight is by and large constant, suggesting the overall risk of the division was broadly unchanged. However, from the review of the division's asset quality (see Section 2.4) it is clear that Corporate's risk profile increased markedly over this period and in particular in the years 2006 and 2007. The Basel I regime was not sufficiently risk sensitive to take account of the changing risk within HBOS, and neither the firm nor supervisors took sufficient steps to remedy this.

617. Following on from this, if a firm used or relied upon the Basel I capital requirements as part of its pricing or performance measurement, it was under-pricing or misallocating resources. In the case of HBOS, it employed a Shareholder Value Added (SVA) metric as one of its measures to assess performance. This was calculated as a fixed percentage of the division's risk weighted assets. In the case of Corporate, as the risk increased, but risk weights remained constant, the Group overstated the return for the risk taken. It is not clear this metric was a significant influence on the decision making of the firm but nevertheless it could have contributed to a perception that the Corporate Division's performance was better than it was.(145) This weakness in Basel I also contributed to adverse selection. Firms were incentivised to seek higher-risk assets to generate higher returns as the measure of risk calculated using the Basel I methodology

(145) SVA was first implemented in the Group Business Plan 2004 – 2008, and it was recognised it would take some time before it became fully integrated into decision making.

2

did not increase and so they could obtain an apparent but illusory improvement in returns on capital or risk.

618. It was this lack of risk sensitivity in Basel I that Basel II was seeking to address with its new approaches to assessing credit risk.

2.9.6 HBOS's loss absorbing capacity

619. As at 31 December 2007, HBOS had £22.2 billion of equity. Despite a £4 billion share issue, this had declined to £21.5 billion by the end of September 2008. This was only marginally more than the subsequent net losses that HBOS recorded from October 2008 to the end of 2011 (Table 2.24). The losses were reduced by various actions by LBG, such as a subvention[146] payment of £3 billion in 2009 and capital management exercises in 2009 and 2010. Without these actions the losses would have been significantly above shareholders' equity as at September 2008.

620. Both LBG and the UK Government also injected new share capital into HBOS in 2009. Without the various actions by LBG and the UK Government to cover the losses, the Group would effectively have become insolvent.

Table 2.24: Movement in total equity between 2007 and 2011[a]

	£
Total equity as 31 December 2007	22.2
Net losses (January to August 2008)	(0.3)
HBOS April 2008 share issue	4.0
Dividends[b]	(1.3)
Shareholders' funds as at August 2008[c]	**24.6**
September results[d]	(3.1)
Shareholders' funds as at September 2008[e]	**21.5**
Cumulative loss October 2008 to 2011 (after inclusion of a subvention payment of £3 billion from LBG and gains of £2.9 billion on LBG's capital management exercises in 2009 and 2010)	(21.3)
UK Government capital injection 2009 (£8.5 billion ordinary shares and £2.8 billion preference shares)[f]	11.3
LBG capital injections 2009[g]	14.0
LBG capital management exercise 2009 and 2010[h]	2.6
Redemption of UK Government and other preference shares 2009	(4.3)
Other reserve movements	0.4
Total equity as at 31 December 2011	**24.2**

(a) Source: HBOS *Annual Reports and Accounts*, HBOS Board management information and Review calculations.
(b) The final 2007 ordinary share dividend (£1.2 billion) and preference share dividends.
(c) The last reported position in the management accounts prior to 1 October 2008, the point of failure.
(d) Due to Corporate impairment losses, the effects of market dislocation in September on security values and write-down on BankWest.
(e) Shareholders' funds reported in the management accounts as at the approximate point of failure, but prepared after that date.
(f) The measures announced by the UK Government 8 October 2008. The £2.8 billion preference shares are net of expenses (£0.2 billion).
(g) These injections were also used to redeem HBOS preference shares (including those issued to the UK Government).
(h) The various capital management exercises raised £5.5 billion in 2009 and 2010, of which £2.6 billion was recognised as share premium on the conversion of debt into shares and £2.9 billion was recognised directly in the income statement, as the debt was bought back at below its carrying value.

621. Both the firm's Tier 1 (£27 billion) and Total Regulatory capital (£40 billion) as at September 2008 were greater than its total equity. The additional capital items included £6 billion of preference and preferred securities and £15.5 billion of subordinated debt. Total regulatory capital held of £40 billion was also considerably higher than the £21.3 billion cumulative loss subsequently incurred.

622. However, the additional capital instruments within Tier 1 and Total Regulatory capital were not capable of absorbing the losses that the Group incurred. The obligation to pay dividends,

(146) Funds provided by LBG to HBOS that did not require repayment and so could count as income and capital.

coupons and repay the principal on the majority of these instruments was unaffected by the financial crisis (i.e. HBOS continued to have a contractual obligation to make the payments). On others a fear of the market's reaction meant potentially discretionary coupons continued to be paid.

623. HBOS also called its issue of JPY60 billion 0.55% Subordinated Callable Notes (2013)[147] in July 2008 when the coupon rate changed (stepped-up), rather than choosing to hold the instrument to maturity. The step-up was a contractual term in the security that provided for the interest rate to increase on a set date. The term was an incentive for the issuer to call the debt as the new interest rate represented a higher cost, and it was the norm and market expectation that in such cases the security would be called. Failure to do so might have been seen as an indicator of weakness causing loss of confidence, but calling it also led to the temporal subordination in a stressed situation of senior creditors (including depositors) to supposedly subordinated capital providers, as the holders of capital were repaid first.

2.9.7 Basel III estimates

624. Basel III is part of the response to the financial crisis and represents higher standards than either Basel I or Basel II. It was obviously not in force during the Review Period and so there is inevitably an element of speculation as to what the position might have been had it been in force at the time, not least because HBOS's actions prior to the crisis would have been influenced by the applicable regime. We are retrospectively using Basel III for two reasons: in part to test and assess the current regime; and provide the context to enable a limited comparison to be drawn as to how regulators and market participants would view HBOS by today's standards.[148]

Minimum risk based capital requirements and buffers under Basel III

625. The Basel III regime comprises a number of elements. These include a requirement to hold core-equity capital in excess of:

- an absolute minimum requirement of 4.5% of RWAs; plus
- a capital conservation buffer of 2.5% of RWAs; plus
- a global or domestically systemically important buffer (maximum of 2.5% or 3% of RWAs);[149] and
- counter-cyclical buffers (to be set by national supervisors).

626. Under Basel III, a systemically important bank will be required to hold at least 9.5% Common Equity Tier 1 capital during normal times to be able to operate without restrictions (e.g. on its ability to be pay dividends). However, banks will also be subject to the Basel Pillar 2 regime and the counter-cyclical buffer which could further increase their capital requirements.

627. The Review has estimated a Common Equity Tier 1 capital ratio for HBOS as at 31 December 2007 as 4.1% under the Basel III standards.[150] This is below the absolute minimum Basel III standard of 4.5% and suggests HBOS was under-capitalised. If HBOS had met the required

(147) Valued at £267 million as at 31 December 2007 in the *Annual Report and Accounts*.
(148) The Report does not include an assessment of the Total Loss Absorbing Capacity proposals of the Financial Stability Board has these proposals have yet to be finalised.
(149) 2.5% is the maximum buffer proposed for use for the largest and most systemically important banks. The Independent Commission on Banking has recommended 3% for the ring-fenced element of UK banks.
(150) This compares to RBS which had an estimated Core Tier 1 ratio of 1.97% as at 31 December 2007: *The RBS Report*.

minimum standard, estimates indicate that it would have needed an additional £1.4 billion of reserves or common equity. Given a shortfall, the firm would not have been permitted to pay a final ordinary dividend of £1.2 billion for 2007 in addition to being required to either raise further capital or manage down its risk.

628. However, to meet the further Basel III standards for the capital conservation buffer (2.5% of Core Tier 1), and the loss absorbency requirement for Global or Domestically Systemically Important Banks, HBOS would have needed around a further £17 billion of common equity or to have reduced its capital needs by de-leveraging or de-risking its balance sheet by a commensurate amount.[151] HBOS would then have also been required to hold further capital to meet its Pillar 2 requirements.

629. The additional £17 billion capital to meet the capital conservation and systemically important buffers would not have been sufficient to cover the net loss of £26 billion reported for the four years 2008 to 2011. It is estimated that the additional requirements of the cyclicality buffer and Pillar 2 would have needed to be between 2.5% and 3% of RWAs to ensure that the Group held sufficient capital to cover the losses, while still holding sufficient capital to meet the minimum 4.5% requirement.[152] Table 2.25 summarises the calculations.

Table 2.25: Summary of the estimated impact of Basel III capital calculations as at 31 December 2007[a]

	£ billion
Additional capital to meet the Basel III:	
Minimum standard (4.5%)	1.4
Capital conservation buffer (2.5%)	7.7
Systemically significant buffer (3%)	9.4
Sub-total	**18.5**
Pillar 2 capital requirement and other tools (2.5% – 3%)	8.9
Total additional capital requirement	**27.4**
Less additional capital to meet the minimum standard. This is on the assumption that the firm must still meet this requirement while covering its losses.	(1.4)
Additional capital required by Basel III available to cover losses	26.0
Cumulative net loss 2008 to 2011	26.0

(a) Source: firm regulatory reporting to the FSA, *Annual Report and Accounts* and Review Calculations.

630. In the years immediately preceding 2007, HBOS's Basel III core equity ratio is estimated as having moved in the range 4% to 5%. In no year would the firm have come near to holding sufficient capital to satisfy the capital conservation or other buffers.

631. Assuming the firm had not held the necessary capital to satisfy the Basel III requirements, it is unlikely it would have paid an ordinary dividend or undertaken the share buybacks in the years covered by the Review Period. In total, these restrictions would have preserved £8.1 billion of reserves or common equity.[153] This is smaller than the potential additional requirement of £18.5 billion. The capital saving would not have been sufficient to cover the losses or to have enabled the Group to meet the Basel III requirements.

632. It seems likely that HBOS would have responded to a Basel III regime by significantly amending its business model. For example, the Group may not have pursued the significant asset growth that it achieved; it may not have undertaken more risky lending, such as leveraged loans and specialised mortgages, which required higher capital under the Basel II models, in particular in a

(151) The Review has assumed HBOS would be a Domestically Significant Bank and has applied a 3% requirement to the total Group.
(152) If the firm was also required to maintain the systemically important buffer while meeting losses, the Pillar 2 requirement would need to be larger.
(153) The firm paid ordinary dividends of £5.6 billion in cash for the years 2005 to 2008; and bought back its own shares at a cost of £2.5 billion in the years 2005 to 2007.

time of stress due to the pro-cyclicality of the models; it may not have permitted exposures in higher risk sectors (commercial property); and large individual borrowers to become so concentrated to minimise Pillar 2 capital charges. It also seems likely these actions would have been taken early in the Review Period.

633. Relative to peers, HBOS did not have the lowest capital ratio as at 31 December 2007 (that was RBS at around 2%), but it was below the peer group average of 5.03%. Other things being equal, it seems likely that, given the Pillar 3 disclosures and general approach to be seen within the peer range, the firm would have taken steps to improve its ratio in this circumstance.

634. HBOS's ROE of around 20% was not dissimilar to peers. From the Basel III calculations, holding an additional £27 billion of equity would have roughly halved the Group's ROE. Other banks would also have been affected, but HBOS more than most, and would have fallen towards the bottom of the peer range. ROE on these levels would undoubtedly have led to a reappraisal of the HBOS business model.

Leverage

635. The financial services industry in general increased its leverage in the years preceding the financial crisis.

636. HBOS's leverage ratio did not significantly increase the risk profile of the firm during this period. However, there was an expectation that Basel II would permit the firm to reduce its capital over time, as it benefited from reduced risk weights on mortgages and other secured lending, which would have freed it to increase leverage.

637. At the end of 2007 HBOS had a consolidated balance sheet (inclusive of insurance) of £667 billion supported by £22 billion of equity. Each billion pounds of equity was supporting about £30 billion of assets.(154) The equivalent figure at the beginning of 2005 was just under £29 billion.

638. Notwithstanding that HBOS met its regulatory capital requirements over the Review Period, and considering the findings from the *Asset Quality* sections, this shows that a relatively small level of capital was supporting a high level of risk, which proved wholly insufficient.

639. Basel III introduces a new 3% leverage ratio limit. This is intended to be a simple, transparent and non-risk based measure that will supplement the risk based capital measure in preventing the build-up of excessive leverage.

640. It is not possible to replicate HBOS's position under Basel III as the data needed for the calculations were not collected at the time. Nevertheless, making some high-level assumptions it is believed that HBOS was around the 3% ratio during the early part of the Review Period, but only fell significantly below that level when the large losses in 2008 dramatically eroded its Tier 1 capital base. The leverage ratio can be useful, but on its own it would not have constrained HBOS from critically increasing the risk profile of its lending.

(154) Including minority interests of £0.4 billion.

2.10 Shifting market perceptions of HBOS

2.10.1 Introduction

641. The purpose of this section is to explain the market's view of HBOS and how this changed over the course of 2007 and 2008. It has primarily been formed from considering broker and analyst notes; rating agency reports; movements in HBOS's share price and credit default swap (CDS) spreads; and interviews, carried out as part of this Review, with market participants.

642. The section is structured as follows:

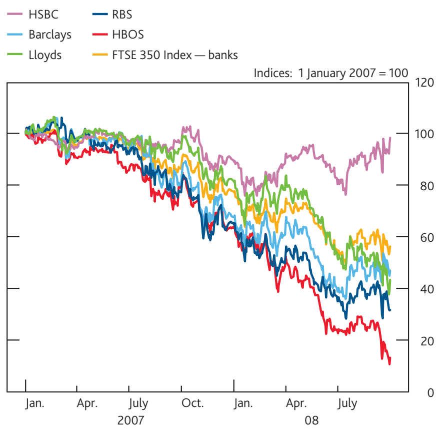
- Section 2.10.2 considers market perceptions of HBOS in 2007;
- Section 2.10.3 considers the changing market perceptions of HBOS in 2008. It particularly focuses on the sudden fall in the share price in March, the rights issue announcement in April, the announcement that HBOS was being acquired by Lloyds TSB in September, and the receipt of ELA in October; and
- Section 2.10.4 reflects the comments and views of a range of market participants who were interviewed as part of the Review.

2.10.2 Market perceptions of HBOS in 2007

643. Up until 2007, HBOS had enjoyed a gradual upward trend in its share price. While it had been buoyed by general market conditions, it had also consistently tracked or outperformed its peers, with total return outstripping the FTSE 350 Index banks and FTSE 100 from late 2005 onwards.

644. In early 2007, there were increasing signs of market uncertainty towards HBOS. By February 2007 (which saw the highest share price recorded, at £11.66 on 22 February), HBOS's share price began to underperform relative to the sector, deteriorating further following the announcement on 28 February 2007 of its preliminary trading results (Chart 2.73).

Chart 2.73: HBOS and UK peer banks' share prices[(a)]



(a) Source: Bloomberg and Review calculations.

645. This results update revealed a 14% increase in Group underlying profit before tax, with double-digit profit growth of at least 17% in all divisions with the exception of Retail (at 4%). Key reasons cited by HBOS for the trading difficulties in Retail were the increasingly competitive environment and rising interest rates. Combined with the pressure to maintain market share, HBOS and its peers experienced an attendant decline in margin.

646. The performance of HBOS's Retail Division remained of primary concern to the market during 2007, in part due to the fact that it accounted for approximately 60% of total Group loans at the time. HBOS's weak mortgage lending as well as the credit quality of the unsecured book were particular areas of focus. HBOS's cautious attitude was also perceived as a sign that the position in Retail would continue to deteriorate.

647. Leading up to, and for most of, 2007, the market viewed the Corporate Division as the key driver of HBOS's growth and profitability, which was outperforming the sluggish Retail Division. There was commentary in 2006 on the opacity of Corporate's book. From the start of 2007 sentiment started to change, as a handful of analysts began to show concern about Corporate's business model.

648. A January 2007 Deutsche Bank report on the prospects of the UK banking sector, for example, expected that: *'an improving outlook for UK unsecured lending and continued good conditions in residential mortgage and corporate lending will see the domestics turn in another strong performance in 2007'.* However, the report stated that: *'we believe HBOS is amongst the most exposed UK banks should the highest risk corporate sector credit cycle deteriorate in 2007'.*

649. This view echoed similar concerns raised by UBS in the same month, in a report that examined the Corporate Division in extensive detail[(155)(156)]:

- *'HBOS already has a uniquely concentrated retail balance sheet for a large European bank. The strength of the UK residential market suggests this is likely to prove a benefit rather than an issue in the next year. But to then build its corporate bank around UK real estate is only to emphasise the concentration risk. And to increase the most subordinated (equity) and highly-leveraged positions within that seems to layer on further concentration. Finally, as if to take things to their logical conclusion, HBOS is already the owner or is bidding to become the owner of three of the UK's largest construction companies with acquisition values in excess of £4 billion.'*

(155) The UBS report's overall stance on HBOS remained neutral.
(156) Source: UBS Investment Bank Research report on HBOS entitled "Corporate: Enjoying the cyclicality" dated 5 January 2007 © UBS AG.

- *'…the corporate bank is becoming a real-estate and private equity focused conglomerate relatively late in the cycle. We believe that the illiquid nature of these positions, their equity-like volatility and the very low related costs make the earnings from HBOS' Corporate bank uniquely cyclical.'*

- *'Being at every level of an investment should provide attractive returns while conditions are favourable. But there is no liquid market for these positions in less benign times.'*

- *'….we regard the illiquid portfolio … of HBOS Corporate as likely to see the greatest negative UK operating leverage in a downturn.'*

650. Another broker noted similar concerns through 2007, questioning the sustainability and quality of Corporate's gains, especially in a downturn. In one report, it noted: '*the company appears to be relying on an increased contribution from the Corporate Banking division, particularly its equity type gains. Although HBOS insists these are sustainable and part of its business model, we continue to regard them as lower quality earnings*'.

651. Some of these concerns were apparent during HBOS's presentation to analysts as part of the 2006 preliminary results announcement in February 2007. One specific comment focused on the loan syndication strategy: *'the stuff* [that Corporate is] *holding on to is both higher margin but also higher risk, potentially leaving you with a big bath down the line, as losses start to rise. Can you give us some reassurance that's not the case, and help us to understand how we can see that from the numbers that you are reporting?'* HBOS responded that the residual book was not higher risk and that HBOS's equity exposures of £2.5 billion were only 3% of the corporate book. Interestingly, Mr Hornby added that: *'our origination capability has grown so strong that…we have to keep asking ourselves whether we are right to be selling down quite as much as we are'.*

652. As 2007 progressed, market sentiment towards the UK mortgage market turned negative. The *Financial Times* House Price Index report for May 2007, for example, noted that: '*Market indicators from across the property purchase process (enquiries, mortgage approvals, transactions) show clear evidence of the slowdown and support our assessment of the flattening price trend. Interest rate increases will continue to bite, not least upon the many thousands of borrowers who have taken out fixed rate mortgages since mid-2005 (typically for 2/3 year periods).'*(157)

653. Concerns regarding the slowdown, including rising impairments and slowing revenue growth, were echoed in brokers' notes. The monoline UK mortgage banks increasingly became a sector of concern. Northern Rock was often identified as the highest risk of the peer group, which also included Alliance & Leicester and Bradford & Bingley.

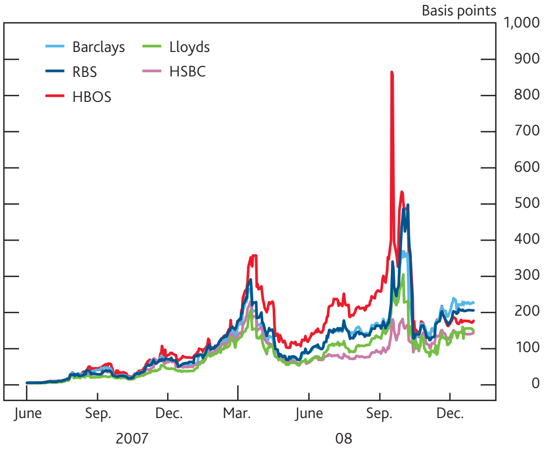
654. At this point, HBOS was generally still considered alongside such banks as Lloyds TSB and Barclays, which were expected to provide more positive trading updates than the mortgage monolines. Nonetheless, the market remained broadly bearish, its view not helped by expectations of several interest rate rises which were likely to impact volume growth and customer credit performance.

655. Following further market turbulence, the next major results announcement by HBOS on 1 August for the half year to June 2007 revealed declines in both market share and margin in Retail, in part due to a change in strategy, as well as increasing competition.

656. The results confirmed forecasts by brokers, who believed that, particularly in light of the environment, Retail would continue to underperform and the earnings mix would continue to be skewed towards Corporate.

(157) Source: Academetrics, FT House Price Index May 2007, 8 June 2007, http://www.acadametrics.co.uk/FTHPI%20Press%20Release%20May%2007.pdf

Chart 2.74: Large UK banks' three-year CDS spreads on subordinated debt, June 2007 to December 2008(a)



(a) Source: Bloomberg.

657. While concerns about Retail dominated much of the HBOS coverage during the summer, asset quality also began to emerge as an area of greater interest. For instance, one Lehman Brothers report noted the problematic valuation of the firm's £2.9 billion investment portfolio and its gains, pointing to the opacity of the book's likely mark-to-market value. While *'management appeared optimistic that the growth in the portfolio implies sustainable and growing contributions in 2008'*, the report itself was more sceptical.

658. As the financial markets continued to deteriorate, HBOS's share price began to deviate more widely from its peers, as shown in Chart 2.73 above.

659. By early August 2007, money markets had frozen, with limited liquidity available not only for HBOS but also its peers. This resulted in HBOS offering financial support to Grampian, its ABCP conduit, the biggest ABCP issuer in Europe. At the time, the market did not appear to flag this as a significant concern, given that the tightening of funding was a market-wide issue. Standard & Poor's (S&P), the credit rating agency, stated that HBOS's rating was unaffected by the decision to use its liquidity lines to fund Grampian, reflecting '*the credit quality of HBOS … and the conduit's ability to draw liquidity due to the high credit quality of the underlying assets*'.[158]

660. Ongoing problems at Northern Rock culminated in the extension of ELA on 14 September 2007, which led to the market becoming more concerned about the sector as a whole, reflected in the spike in the LIBOR-OIS spread (Chart 2.9), the decreasing share price of HBOS and its peers (Chart 2.73), and the creep upwards in CDS spreads (Chart 2.74). On the latter measures, HBOS increasingly became the worst performer of the large UK banks.

661. HBOS's pre-close trading update on 13 December 2007 announced more negative news, leading to an 8% decline in the company's share price. Alongside the continued deterioration in Retail, strong Corporate asset growth was revealed (a consequence of '*…good new business volumes and a slowdown in syndication activity since August*'), and that the projected Tier 1 ratio for the year end would be around 7.5%, below the firm's normal target.

662. At this time, further details of HBOS's exposures to ABS and sub-prime assets were also disclosed, with write-downs on the Treasury portfolio of £180 million for traded investment securities (taken to the income statement) and a further £370 million on assets within the

(158) Source: Standard & Poor's Bulletin: HBOS PLC Ratings Unaffected by Decision to Fund Grampian ABCP Conduit, 22 August 2007.

Group's AFS reserve (not taken to the income statement), of which £30 million was sub-prime (out of a total £430 million exposure to US sub-prime for the Group as a whole).

663. The conference call transcript to the update indicated analysts' increasing concerns about the asset quality of the overall HBOS book:

- One analyst asked: *'…can you just tell us what your appetite has been like in terms of loan growth in UK commercial property over the last couple of years, and what you've been doing in terms of underwriting? Clearly people are very worried about this.'* The firm responded that it had shifted its focus on new lending in the last 18 months away from the United Kingdom (acknowledging that loan growth in the domestic commercial property market was likely to be modest) to continental Europe and was seeing property appreciation; further, the firm would *'much rather have the security of loan to values in the 55% to 60% range than to be exposed to unsecured lending in these markets'*. Overall, HBOS was *'feeling very comfortable'* about its position.

- Another analyst noted that HBOS's CDS spread had widened more than peers and questioned whether its competitive position relative to funding had deteriorated in the market and *'…in that environment why would you want to look to accelerate asset growth?'* The firm responded that it was *'very comfortable'* with its asset growth and that part of the reason that growth had not slowed down was due to the fact that the corporate world had not necessarily felt the impact of the more turbulent financial markets sufficiently for there to have been a change in demand.

- When asked: *'How long do you think you can go on sustaining a double digit rate of asset growth with the kind of funding conditions that we now have?'* HBOS stated that if market conditions continued, demand in the corporate world would be reduced: *'…this debate as to what level of asset growth you can sustain is answered by the customer in the end'*.

664. A Lehman Brothers report published in December 2007 took a negative stance towards the firm, noting that HBOS appeared the most vulnerable among its peers to deterioration in UK corporate asset quality. Although consensus earnings expectations were being met, the report noted that these appeared to have been achieved with higher investment realisations, leading to concerns about sustainability: *'the group appears to have continued loan growth in the face of funding and distribution pressures. However, there must be a limit as to how long this can continue, as it is eroding funding and capital positions'*.

665. However, there remained some who continued to view HBOS favourably. In particular, a number of analysts considered the stock to be undervalued with the bad news already factored into the share price. One theme appeared to be 'flight to quality' towards HBOS and others after the collapse of Northern Rock:

- *'The de-rating has gone too far…HBOS should show good earnings resilience if times get tougher…we … believe it has the capital strength to take surprises (Grampian) in its stride… HBOS deserves safe haven status…cost efficiency is among the best in the sector and likely to improve still further…should be a beneficiary from Northern Rock's problems'*.

- *'…we believe it is time to differentiate between winners and losers post the woes of Northern Rock. In this regard, we upgrade HBOS from Neutral and add to our Conviction Buy List as we believe current prices more than reflect concerns on liquidity, corporate profitability and mortgage strategy'*.

666. In summary, brokers' views of HBOS were mixed during 2007. Generally HBOS was regarded very positively. Analysis of broker sentiment shows that 'buy' remained the principal recommendation during 2007 (between 50% and 60%) only starting to decline towards year

end. Other brokers were more pessimistic due to concerns about slowing momentum and an impending downturn. The 'sell' recommendations were broadly around 20%, falling to a low of about 10% in September, before rising gradually to reach 20% again by year end.

2.10.3 Market perceptions of HBOS in 2008

667. HBOS's share price deteriorated further in February 2008 following the announcement of its preliminary 2007 results.

668. Information contained in HBOS's December 2007 pre-close trading Statement and the more detailed 2007 Preliminary Results announcement made in February 2008 appear to have taken the market by surprise and significantly eroded the market's confidence in HBOS. These included:

(a) a decline in the Tier 1 capital ratio;

(b) the continued under-performance in Retail;

(c) a slowdown in syndication and fewer realisations within Corporate;

(d) further disclosure of its debt securities portfolio of £81 billion, of which ABS exposures accounted for £41.9 billion;

(e) a £430 million exposure to US sub-prime ABS exposure;

(f) disclosure of Alt-A assets worth £7 billion; and

(g) a £227 million adjustment due to contagion from the US sub-prime market.

669. This information undermined the markets' confidence in the firm and led to questions about senior management's ability to 'ride out the storm'. HBOS's share price fell by 23% in the following week.

670. Despite the difficulties disclosed, HBOS continued to present an optimistic view, noting that: '… *we are extremely confident that we are emerging from exceptionally tough market conditions with very strong prospects for the future'*.

671. Analysts at the presentation showed concern for the firm's funding position (both its maturity and the replacement of longer term wholesale funding with short term funding), as well as asset quality, particularly in the Treasury portfolio, with one analyst claiming that HBOS's description of Alt-A exposures as '*reasonable*' was '*alarming*'. During the questions and answers session, analysts pointed out that the percentage of HBOS's debt portfolio that was accounted for by ABS exposures (42.4%), although ostensibly held for liquidity purposes, was too illiquid to be marked to market. This was noted as being significantly higher than that of HBOS's peers (typically 20-25%). Several analysts repeatedly pressed management to comment on its capital ratios.

672. Concerns were echoed in some broker reports at the time, e.g. Deutsche Bank noted:

- '*…the fact that management did not take the opportunity in December to let the market know about its £7bn holding of US Alt-A mortgage-backed securities is awkward given obvious market interest and broader disclosures by some of the peer group.*'

- '*…we expect the risk-asset portfolio will be an enduring issue* [because] *the process around, and extent of, fair value adjustments leave us expecting impairments in 2008'*, with the report further noting that *'HBOS* [was] *of the view that all bonds will repay and that the value changes will be reversed. This is a significantly more confident stance than we've seen from the other UK banks…'*

- '*We expect investors will remain concerned…until debt market conditions improve or the portfolio has become significantly smaller.'*

- '*We see no easy or early solution to the current lack of competitively-priced term funding for banks and expect margin pressure will remain …. In this, HBOS is the least favourably positioned of the large UK banks.'*

673. Other brokers made similarly negative comments:

- *'Disclosure fails the test'; 'corporate credit quality deteriorates'.*

- HBOS *'has more issues that are likely to drag on performance'* compared to Lloyds TSB, including the prospect of further fair value adjustments, funding, the closure of securitisation markets and the deterioration of UK corporate credit quality.

- *'…the market had been concerned about the Retail performance (specifically margin/funding, mortgage bad debts, and profit progression), treasury write-downs, over reliance on corporate realisations/commercial property exposure and capital strength. Overall we feel higher corporate bad debts and the new Treasury disclosure will lead to concerns.'*

- *'We believe that any deterioration in UK loan quality is likely to be concentrated in the areas of real estate and leveraged loans, the two principal sectors where corporate leverage has increased at an above-average rate'; 'we had viewed HBOS treasury as primarily a source of liquidity, rather than a revenue generator in its own right. The existence of sizable exposures…is therefore a surprise.'*

674. Confidence in the firm appears to have been shaken. Many brokers adjusted their target price of HBOS downwards, and HBOS's share price had fallen by 18% at the end of February 2008 from the beginning of the year. Chart 2.73 shows that by this point, HBOS's share price was significantly adrift of the FTSE 350 bank index and the worst performing of its immediate peers.

Rumours incident and FSA investigation

675. HBOS's already fragile position was further tested less than three weeks after the results announcement. On 19 March 2008, a British bank was rumoured in the markets to be facing severe strain including difficulties securing funding amid *'pessimistic chatter'* following the collapse of Bear Stearns (after which UK bank shares fell between 2% – 13%, with HBOS being the worst performer, its shares having fallen 13% the next day).

676. Some of the rumours identified HBOS by name: *'they contended that the Governor of the Bank of England had cancelled his Easter travel plans in order to resolve a liquidity problem at HBOS; and/or that the Bank of England was "bailing out"*[159] *HBOS'*. News agencies at the time reported the Bank of England's denial that it had cancelled leave for its Monetary Policy Committee (MPC) members.

(159) FSA press release, 1 August 2008, *FSA concludes HBOS rumours investigation*.

677. The rumours led to HBOS's share price falling 17% during the course of the day, during which HBOS, the FSA and the Bank all made statements to calm the markets and restore stability. HBOS share price ended the day at 446p, 7% down from the previous day's closing price.

678. The subsequent FSA investigation into the rumours confirmed that the uncertain market conditions at the time and the emergency sale of Bear Stearns one week earlier, had resulted in traders and other market participants *'very actively monitoring their positions in UK banking stocks (and were prepared to give credence to, and act on, negative market information)'*. The investigation determined that there was a likelihood that the rumours contributed to the fall in the share price, but did not find evidence that the rumours themselves were spread as part of a concerted attempt by individuals to profit by manipulating the share price.

679. The incident – also reflected in the spike in HBOS's CDS spread in March 2008 – highlighted further the high degree of uncertainty in the UK banking sector and HBOS's apparent vulnerability to market gossip at that time.

Rights issue announcement

680. Just over a month after the rumours incident, in April 2008 HBOS announced it would raise capital via a rights issue of £4 billion. The objectives cited were: '*to rebase the Group to stronger capital ratios; to consolidate the Group's strengths in its core markets; to mitigate the increased sensitivity of the Group's regulatory capital of change arising from Basel II; and to accommodate the impact of the Treasury portfolio fair value adjustments*'.

681. Despite these relatively benign objectives, the underlying rationale for the rights issue divided the market. Some brokers considered that additional capital was unnecessary for HBOS given its perceived strong capital position and that the firm was simply seeking to build a buffer for bad times: '*…simply because* [HBOS] *believes that those banks with a superior capital position will outperform less well capitalised banks…*'.

682. Others viewed it negatively and/or with suspicion:

- '*The right answer is not a rights issue…this will destroy significant shareholder value*.'
- '*What doesn't square…is quite why £4bn in capital is necessary … Though HBOS couched the capital increase in the language of creating a competitive advantage…many will wonder, we believe, whether the new capital will not be required to fund increased risk asset-requirements under the pro-cyclical Basel II framework or further potential marks against the risk asset portfolio*.'
- '*We do not believe HBOS has adequately explained its rationale for raising £4bn of equity from its shareholders*.'

683. Bad news relating to peers also had an effect on HBOS – for instance, when RBS took a £666 million write-down on its Alt-A portfolio on 22 April, HBOS saw its shares fall by 3.7% from the previous trading day.

684. The credit rating agencies diverged in their views of these events. S&P issued a statement on 29 April 2008, stating: '*ratings…are not affected by today's announcement of £2.8 billion in negative fair value adjustments against HBOS' securities portfolio, and a £4 billion rights issue. The share issue is aimed at strengthening HBOS' capital position versus its peers…it also supports the*

group's organic business growth'; on the adjustments, it noted 'little evidence of deterioration in the underlying assets'.(160)

2

685. Moody's, however, announced the following day that it would change its outlook on HBOS senior debt to negative, citing concerns that: *'given the size of the structured securities portfolio a further deterioration in market conditions could lead to additional substantial negative fair value adjustments*'. The rights issue, however, was viewed positively, given its view that: *'the bank will face pressure on earnings from a more challenging operating environment across its UK franchise'*.

686. On the same day, Fitch changed HBOS's long-term issuer default rating outlook to negative, citing concerns over the deteriorating conditions in core parts of HBOS's Retail and Corporate Divisions, combined with *'weaker operational flexibility due to continuing disruption/dysfunction in parts of the wholesale funding markets on which HBOS relies quite heavily'*. However, it affirmed HBOS's AA+ rating based on '*its geographical and product diversification, strong franchises, the relatively low risk of its large UK mortgage portfolio, solid prospects for long-term growth and a sound capital base…*' albeit also reflecting weaker revenue and asset quality outlooks for UK mortgages and parts of corporate lending and disruption to wholesale funding.

Continuing deterioration

687. As the year progressed, negative news continued to emerge. UK house prices fell by 2.5% in May 2008, the largest single monthly decline since the Nationwide index began in 1991. UK bank shares fell following the news, with HBOS shares down 3.9% (Barclays -2.5%, RBS -2.6% and Bradford & Bingley -6.9%).

688. June 2008 proved to be another bad news month. Amid bearish macroeconomic news in Europe and the United States, bank shares suffered steep falls – 6 June saw all major UK banks close the day down in excess of 2%, with HBOS the steepest fall at 7.6%. Three days later, Lehman Brothers' announcement of an expected Q2 loss added to the strain, with HBOS falling 7.2%, again the worst performer in its peer group.

689. As HBOS's share price fell to (and momentarily below) the price of the rights issue (275p a share) in June 2008, the extent of brokers' concerns in relation to HBOS and its prospects become more apparent:

- '*…we remain concerned that a significant amount of stock could be left with the underwriters causing an undesirable supply 'overhang' and that further earnings downgrades are more likely than upgrades…we advise clients not to take up their HBOS rights.'*

- *'We viewed the statement and conference call as consistent with a negative outlook for the group and the domestic UK banks, although it did not reveal anything particularly surprising or incrementally negative. However, it did nothing to allay any of the negative concerns either. We believe that HBOS is likely to have to undertake significant changes to its business model in the near to medium term, including its recent growth in corporate lending, mortgages (notably in specialised lending) and reducing its loans/deposits ratio.'*

690. In June 2008, S&P followed its peers and revised HBOS's outlook for its counterparty credit ratings to negative, citing pressure on HBOS's impairment losses and revenues arising from the slowing UK economy and property market. However, it affirmed HBOS's existing 'AA-/A-1+' rating. S&P stated its expectation that HBOS's earnings would decline in 2008 due to three factors: higher write-downs on Treasury assets; lower gains from the Corporate Division's investment portfolio; and rising impairment losses. It further noted that: *'we will pay close*

(160) Source: Standard & Poor's, 'HBOS plc and Bank of Scotland Ratings Unaffected by Markdowns and Rights Issue', 29 April 2008.

attention to the performance of the corporate lending, corporate investment and specialist residential mortgage portfolios, which we view as the most vulnerable to prolonged weakness in the UK economy and property markets'.

691. On the same day, Moody's issued a commentary piece pointing to the negative fair value adjustments as well as the deterioration of asset quality on the mortgage book.

692. News flow was not exclusively negative during this period – for example, the FSA's announcement that it was to demand disclosure of investors' short positions during a rights issue led to a sharp spike of 13.7% in share price. However, a trading update the following week in which HBOS revealed a £1 billion write-down to its Treasury book led to approximately half of these gains being wiped out.

693. Concerns relating to HBOS specifically as well as the banking sector more widely continued to prove problematic for the firm, resulting in the very low subscription rate of 8.29% for the July 2008 rights issue, with underwriters left with the overhang. Both Barclays and RBS announced capital raisings in April; while Barclays' non-traditional rights issue was only marginally more successful, achieving a subscription rate of 19%. RBS's was nearly fully subscribed at 95%.

694. These events serve to illustrate the lack of the market's belief in HBOS's prospects, though they may also point to lack of market capacity or appetite to provide capital, given Barclays' and RBS's capital raising preceded that of HBOS.

695. Both the media and the analyst community focused on the news of the poor take up. *The Guardian* noted the level of support was one of the lowest ever registered for a rights issue and '*deals a blow to HBOS's management*'. Analysts noted: '*it was clear rights take-up was going to be weak*'.

Events of summer 2008

696. Conditions in the wholesale markets continued to worsen in the United States and Europe from July 2008 onwards, with the collapse or near collapse of several well-known financial institutions, resulting in increasing reliance on their respective governments for support.

697. In evidence provided to the FSA, one of HBOS's external auditors commented that after the rights issue there was '*almost daily news flow*' about emerging problems with HBOS's clients – which would have served to worsen market perceptions.

698. By 31 July 2008, HBOS's share price had lost 60% of its value at the beginning of the year. The overall tone on HBOS had become very negative, particularly after its H1 results announcement. Analysts focused in particular on funding and asset quality and noted its relative vulnerability to peers:

- '*A combination of significant structured credit exposures, concentration in UK property, and funding pressures have placed HBOS in the eye of a perfect storm*'; '*in addition to being the UK's largest mortgage lender, 38% of HBOS' corporate loan book relates to the property and construction…an area where we expect significant declines in collateral values and weaker cash flows to result in credit losses*.'

- '*The deterioration of credit quality sooner and more sharply than forecast across all divisions is expected to be exacerbated in future by higher levels of default and higher average loss given default*'; '*HBOS expected to show the weakest credit performance of the UK large cap banks*'; and as the value of impaired loans against which a loss was expected grew faster than the value of impaired loans against which no loss was expected: '*this is either as a consequence of*

2

a higher proportion of new counterparties-in-arrear expected to cause losses to the bank or loans previously regarded as No loss are having to be re-categorised as collateral values fall, or both, in our view. Neither are a good sign for credit performance…'

- '*Figures showed sharply rising impairments/impaired assets. We would argue that the cost of the coming credit cycle is the most significant threat to bank value and HBOS appears more than averagely exposed. We regard the stock as the most geared investment to an economic recovery among the major domestic UK banks. We therefore continue to regard it as unattractive...'*

- '*…multiple risks remain, not least the significant residual structured credit exposure and the large wholesale funding needs of the business.'*

- One broker went further to say '*we believe the market sees a very real (implied 48%) chance of insolvency*', though it did not believe HBOS would become insolvent '*but rather that it offers exceptional value*'.

699. Ideas to improve HBOS's position, particularly its ever increasing wholesale funding gap, were increasingly mooted (notably the sale of its Australian operations) evidencing analysts' view that HBOS was in an increasingly unfavourable position.

700. However, not all commentary was negative. For instance, one broker noted HBOS offered compelling risk/reward, given it was trading at an all-time low in terms of franchise value. Another considered that the general market concern was *'overblown … a material downturn is now more than captured by the lowly 2008e 0.7x price to tangible book valuation'* and any issues of substance were already priced into the market valuation.

Events of September and October 2008

701. The collapse of Lehman Brothers on 15 September 2008 resulted in wholesale funding becoming even scarcer for the majority of UK banks and building societies, as markets lost confidence that certain institutions were 'too big to fail'. Combined with the market's negative view of HBOS, the increasing challenges of the firm to secure sufficient funding and at a suitable tenor made its position more fragile and vulnerable.

Downgrade by credit rating agencies

702. On 16 September 2008, HBOS was downgraded by two credit rating agencies. S&P said that the downgrade from AA- to A+ reflected its opinion that HBOS's financial situation was less well positioned to manage the deteriorating operating environment than AA-rated global peers:

- '*The main differentiating factor in our view is credit risk. This reflects the sizable role for both specialist and high loan-to-value (LTV) mortgages in HBOS' UK mortgage book and its weaker profile corporate book. We also note that earnings may be constrained by higher funding costs given that HBOS is less well positioned. HBOS' ratio of total loans to customer deposits, 178% at June 30, 2008, is higher than many similar rated peers. Earnings will also be affected by weaknesses in its corporate investment portfolio, and further credit market-related write-downs, which cannot be ruled out, add to this pressure.'*

- '*The corporate book is a further cause for concern. We consider that the overall profile of this book is weaker than peers'. In part, this reflects HBOS' tendency to avoid low margin relationship banking and instead specialise in entrepreneurial, transaction-based products such as asset finance and acquisition financing. Loan impairments…are on an upward trend and we expect this to continue.'*[161]

(161) Source: Standard & Poor's Ratings, 'HBOS Plc ratings Lowered to A+', 16 September 2008.

703. Fitch downgraded HBOS from 'AA+' to 'AA', citing '*heightened concerns over the outlook for core parts of HBOS's retail banking (e.g. mortgage portfolios) and corporate banking (e.g. property-related exposures) divisions*' alongside the weaker operational flexibility due to continuing disruption and dysfunction in parts of wholesale funding markets on which HBOS relies, first mentioned in April 2008.

Acquisition by Lloyds TSB

704. On 17 September, two days after the collapse of Lehman Brothers, HBOS confirmed it was in discussions with Lloyds TSB over a possible deal. A formal announcement was made by Lloyds TSB the following day of its intention to acquire HBOS for £12.2 billion, causing a temporary 17% spike in HBOS's share price.

705. Analysts expressed a range of views regarding the acquisition. There was clear relief immediately after the announcement which '*helped to restore confidence and break the infernal spiral in which HBOS was engulfed*'.(162) There was also sentiment that in the longer term this could be a positive for the enlarged Lloyds Banking Group on account of the larger customer base, greater degree of diversification, and cost synergies.

706. However, in the short to medium term, consensus was on balance negative. For example, Goldman Sachs removed HBOS and Lloyds TSB from the UK Relative Value List. Deutsche Bank noted that the deal saw '*Lloyds TSB sacrifice the attributes investors valued most: (1) a defensive loan book, (2) a relatively liquid and well-capitalised balance sheet, and (3) a premium dividend yield*'; it also commented that putting the banks together would not reduce the quantum of funding required.

707. There was also commentary on the broader policy context. One broker noted: '*the takeover may be viewed as negative… could be seen as an admission that they* [the Regulator] *and/or the Bank of England were unable or unwilling to inject massive liquidity to prop up the country's largest mortgage provider*'.(163)

Receipt of ELA

708. Concerns reached crisis point at the end of September, with increasing media focus on HBOS. *The Telegraph*, quoting an estimated £198 billion wholesale funding requirement (the largest in the industry), wrote: '*With the markets shut and no apparent means of funding for the foreseeable future, short sellers turned on the UK's easiest target – HBOS … traders knew the enormous obligation could kill it. Seeing the lender under pressure and fearing a repeat of Lehman's, long-only institutions started bailing out as well*'.

709. By 1 October 2008, HBOS was unable to raise new money to meet claims as they fell due and so sought ELA from the Bank of England (see Sections 2.8, '*Funding and liquidity*' and 4.8, '*Contingency planning*').

710. Shortly after, the UK Government announced a recapitalisation package to increase banks' Core Tier 1 capital ratios. Participating banks could either obtain capital through the UK Government's recapitalisation scheme or raise capital in the markets.

711. HBOS was one of three major UK banks in receipt of financial support through this scheme, receiving an £11.5 billion injection of capital from the UK Government in exchange for £8.5 billion in ordinary shares and £3 billion in preference shares. Lloyds TSB received a capital injection of £5.5 billion, which also served to facilitate the acquisition of HBOS. Shortly after, Lloyds TSB announced a £4 billion reduction in the offer price for HBOS.

(162) Source: Fortis, 'HBOS' acquisition by Lloyds TSB: Last Chance Saloon', 18 September 2008.
(163) Source: Fortis, 'HBOS' acquisition by Lloyds TSB: Last Chance Saloon', 18 September 2008.

Market indicators

712. Market metrics show a stark picture – by the end of September 2008, HBOS had experienced an 87% decline in its share price since January 2007, compared to 44% for the sector as a whole (Chart 2.73), while CDS spreads spiked to almost 900 basis points, just under double that of the other major UK banks.

713. The start of 2008 was a pivotal moment. Brokers' 'sell' recommendations (as a percentage of all recommendations) rose consistently each month from about 20% at the beginning of the year. The percentage stabilised in the summer when around 40% of brokers' notes recommended selling HBOS shares. The events of September and October do not seem to have had a significant effect, although by this time the acquisition by Lloyds TSB and the UK Government support measures were on the table to mitigate any further escalation of issues.

2.10.4 Market discipline

714. Unfortunately, there did not appear to be any attempts by the market to exert discipline on HBOS in the earlier years of the Review Period.

715. The Review conducted a number of meetings with market participants to gather a range of views, albeit with the benefit of hindsight. Their comments repeated many widely held views or confirmed the findings reported in earlier reviews of the financial crisis. In particular, a strong theme that emerged from these meetings was that market discipline is difficult to enforce, especially in banking, a business built on confidence and where, in a febrile market, any sign of negativity could exacerbate the situation and lead to a very aggressive market response. In contrast, in an expanding market, even analysts with sceptical perspectives on a particular firm have little incentive to issue a 'sell' recommendation when the rest of the market is far more positive.

716. One market participant, when attending a HBOS dinner, noted how he was left with the impression that the average shareholder at the dinner had very little understanding of banking, everyone was simply focused on earnings. In general, the market participant referred to equity and debt investors as *'comically sanguine'* before the crisis took hold. These characteristics would have made enforcing investor discipline difficult.

717. There is evidence that discipline improved from 2007 onwards as several market participants began selling their holdings in summer 2007, and one participant noted that questions were raised about the HBOS CEO to the Chairman in May 2008. However, some market participants pointed out that the financial crisis became a policy issue towards the end of 2008, with investment decisions being taken based on whether the authorities would intervene – i.e. whether firms were 'too big to fail'. One market participant noted the fact that the lack of certainty of assistance was an important factor affecting market perceptions of UK names, making them more vulnerable. This was in contrast to some other countries.

718. Market actions generally proved to be reactive, and, ultimately, untimely. Negative market sentiment was growing, and market participants were keenly aware that actions taken by a firm could 'spook' the market. Banks are typically highly leveraged which means that when it goes wrong, it goes wrong very quickly. Therefore, there was recognition that banks needed to tread carefully, especially during turbulent times – while some actions may be 'numerically sensible', this needs to be balanced with the impact on market sentiment and potentially triggering a loss of confidence, which by 2008 had become a very real issue for HBOS.

719. The task of exerting market discipline was not helped by the limited frequency of, and detail provided by, disclosures required of firms during this period. When HBOS provided more detail

in its December 2007 pre-close trading Statement and 2007 Preliminary Results announcement in February 2008, it appears to have taken the market by surprise and the subsequent market reaction (HBOS share price fell by 23%) is a case in point. With limited detailed information available to the wider market so that the analysts could not make well informed judgments, greater emphasis was placed on statements made by a firm's senior management.

720. Another point made by the market participants was that there was excessive focus by firms on profits and losses. This was engendered by analysts and the market as a whole which, prior to the crisis, rewarded short-term measures such as high earnings per share, share buybacks and high dividend pay-outs rather than longer term measures such as prudent capital positions. One market participant noted that equity investment is fundamentally based on the premise of growth, and therefore focus on related metrics will continue – '*if you want* [the certainty of getting] *your money back, you invest in bonds'*.

721. Finally, several market participants noted that no one anticipated the scale of the financial crisis – there was a 'collective failure of imagination'. One participant felt this was particularly the case for HBOS (notably the Corporate Division which predominantly came out of Bank of Scotland) and which had been 'less badly burnt' than some other banks in the previous downturn in the 1990s.

722. The inevitable time lag in information flows to external parties and the often asymmetric nature of this information means that market discipline will always be imperfect. This suggests a need for caution in placing reliance on market discipline as a tool to achieve regulatory goals, particularly while some firms are considered 'too big to fail'.

Box 2.5: Credit rating agencies and the use of ratings

Credit rating agencies have played a long-established role in capital markets, providing investors with an independent assessment of the relative probability of default of credit securities (e.g. corporate and sovereign bonds, commercial paper, state and municipal bonds). This is a valuable role since: (i) good investment practice should seek diversification across a wide spread of investments; and (ii) it is impossible for all but the very largest investing institutions to perform independent analysis of a large number of issuing institutions.

Prior to the financial crisis, ratings provided by agencies appeared to be reasonably effective, giving fairly good predictions of the relative credit risk of different bonds. As a result, many institutions chose to embed ratings-based rules in their operating procedures, e.g. a bank restricting its corporate treasury department to making deposits only with banks ranked above a certain rating; or an insurance company or pension fund aiming for a portfolio of bonds meeting the requirements of a defined ratings-based mandate.

While this was known to create some pro-cyclicality within the system (e.g. a bank subject to a downgrade due to financial weakness would automatically suffer the withdrawal of deposits, exacerbating this weakness) this was not considered to be a major concern prior to the financial crisis.

However, in practice, the credit ratings based system played an important role in the origins of the crisis for three interrelated reasons:

- The role of securitised credit increased hugely in importance with the development of structured credit. As a result, so did the dangers that hard-wired rating pro-cyclicality would contribute to a self-reinforcing downturn. The growth of the credit derivatives market for instance, created the possibility that the use of credit ratings in counterparty collateral arrangements would produce a strongly pro-cyclical effect: this danger crystallised in the case of AIG in September 2008, where a threatened rating agency downgrade led to severe liquidity strain. As a greater proportion of securitised credit was held not by end investors intending to hold to maturity (and therefore interested solely in probability of default) but by investment vehicles (e.g. SIVs and mutual funds) performing maturity transformation, some of these investors seem to have assumed, quite wrongly, that a rating carried an inference for liquidity and market price stability, rather than solely for credit risk.

- The ratings of structured credit proved more volatile than the historical record for single name credits. This breakdown in rating effectiveness reflected: (i) the fact that ratings were being extended to instruments where there was limited historical experience; (ii) the enormous complexity of many structured credit instruments; and (iii) a misplaced confidence in the ability of mathematical modelling to define the risks. The resulting instability of ratings not only produced direct pro-cyclical effects, but undermined confidence in the future stability of credit ratings.

- Finally, there have been concerns about whether the governance of rating agencies adequately addressed issues relating to conflict of interest and analytical independence. Rating agencies competing for the business of rating innovative new structures may not have ensured that commercial objectives did not influence judgements on whether the instruments were capable of being rated effectively. The practice of making the models by which agencies rated structured credits transparent to the issuing investment banks also created the danger that issuers were 'structuring to rating' i.e. designing specific features of the structure so that it would just meet a certain rating hurdle.

2.11 HBOS financial reporting

2.11.1 Introduction

723. In its *Annual Report and Accounts* for the year ending 31 December 2007 (published early 2008) HBOS reported a profit before tax of £5.5 billion. The annual accounts for 2008 (published early 2009) showed a loss of £11 billion.(164) In its half-year interim results for the year to June 2008, the charge for Group impairment losses was £1.3 billion; yet by year-end 2008 this figure had risen to £12 billion.(165) The deterioration in the performance of HBOS's loan book and the speed with which it all happened, are a notable part of the HBOS story.

724. This section draws extensively on the published annual reports and accounts and the various interim financial statements issued by HBOS in relation to the Review Period. It also draws heavily on the audits and other reviews and reports which were presented to HBOS's Board and senior management by KPMG.(166) This material is included to show how the losses emerged over time, what information was available to HBOS's Board and senior management, what warnings were given to HBOS's Board and senior management, what decisions were taken as a result, and how these losses were recognised in the published financial statements. It is not within the Terms of Reference for this Review to opine on the content of the annual reports and accounts or the various interim financial statements which HBOS issued throughout the Review Period. Similarly, it is not within the Terms of Reference for this Review to opine on whether the formal audits, reviews or other work undertaken by KPMG in relation to HBOS met the required standards – these are matters for the Financial Reporting Council (FRC). With that in mind, in the course of the Review the Prudential Regulation Authority (PRA) and Financial Conduct Authority (FCA) remained in regular contact with the FRC and wrote to the FRC inviting it to consider whether there were grounds to investigate KPMG and/or senior KPMG people in relation to the audits of HBOS's financial statements for 2007 and 2008 and, by extension, HBOS senior management. The FRC carried out a review into these matters and advised that the criteria for commencing an investigation were not met. The FRC has indicated that it will consider any relevant new information contained in the HBOS Report once finalised and published.

725. As the largest losses experienced by HBOS were in its Corporate Division (see table below) this Section primarily focuses on that division. Significant losses also arose in HBOS's Treasury Division and its International Division. An analysis of Treasury is presented later in this section from paragraph 788 onwards and in Section 2.7, *'Asset quality – Treasury Division'*. An analysis of the performance of the HBOS International Division is set out in Section 2.5, *'Asset quality – International Division'*.

(164) Subsequently restated to £12 billion – see footnote below.
(165) Subsequently restated to £13.5 billion. As explained in note 1 of HBOS's 2010 *Annual Report and Accounts*, the 2008 impairment loss was restated following a market-wide change/clarification of the accounting treatment of treasury assets by IFRIC, the interpretive body of the IASB.
(166) KPMG was HBOS's external auditor from the Group's foundation in 2001 until the year-end 2008, having successfully retendered for the account in 2006. In addition to its statutory audit work, KPMG undertook a number of interim reviews for HBOS, including half-year interim reviews, a working capital review for the 2008 rights issue and a 2008 Q3 'no significant change' review which was necessary before the HBOS Board could issue 'comfort letters' in advance of the merger with Lloyds TSB.

2

Table 2.26: Published impairment losses HBOS Group 2008[a]

£ billion	Impairments to end-Q2 (as per Interim Results published 31 Jul 2008)	Impairments to end-Q3 (as per IMS published in Nov 2008)	Impairments to end-Nov (as per interim Trading Update published Dec 2008)	Impairments to year-end 2008 (as per Annual Report and Accounts, published Feb 2009)
Retail	0.7	1.2	1.7	2.2
Corporate	0.5	1.7	3.3	7.4
International	0.1			1.0
Treasury and Asset Management	nil	0.5		1.4
Other/rounding adjustment				0.1
Total	**£1.3 billion**	not published	not published	**£12.1 billion**

(a) HBOS published a 2008 half-year financial statement, a Q3 Interim Management Statement Interim Trading Update, and a 2008 Annual Report and Accounts.

726. It is worth noting that the financial reporting framework and standards applicable at the time required all firms (including HBOS) to use an 'incurred loss' approach to determining when its loans had become impaired and when provisions were required. Under the 'incurred loss' approach, a loan loss provision is made only if a loss event has occurred which has an impact on the estimated future cash flows arising from the loan. This involves:

- an objective assessment of whether a trigger event has occurred, for example a missed payment or, more often with Corporate loans, a breach of covenant;
- a judgement of whether a loss is likely; and
- a judgement about the size of the likely loss.

In the absence of a trigger 'loss-event' the prevailing accounting standards do not allow provisions to be made for losses that might be anticipated.[167] Therefore, in a rapidly deteriorating commercial property market, a firm might anticipate a corporate loan going bad. However, until a trigger event materialises, the firm is not permitted to make provision for that loan.

727. The dramatic rise in Corporate loan impairments from £0.5 billion in 2007 to £6.7 billion at the end of 2008 is therefore in part likely to reflect the fact that 2008 saw a rapid increase in defaults and covenant breaches in the commercial property sector as the financial crisis began to take hold. However, as set out later in this section, it is also clear that, as the deterioration of the economy accelerated, the HBOS Corporate Division business functions[168] and senior management were slow to recognise objective trigger events and to escalate distressed loans for assessment. Even when a trigger event was recognised, they were reluctant to accept that a loss would be incurred and continued to believe in their ability to execute long-term 'workout solutions' that would enable them to exit the loans without loss; and finally when obliged to book an impairment loss they continued to exhibit a level of optimism in estimating the likely loss which was at odds with the objective evidence available at the time. These factors may also have contributed to the remarkable jump in Corporate impairments from £1.7 billion for the first nine months of 2008, to £6.7 billion in the year-end financial statement. A further factor may be indicated by the statement in HBOS's Annual Report and Accounts for 2008 published in February 2009 that: '*The higher impairment losses in Corporate were also the result of applying a provisioning methodology more consistent with that used by Lloyds TSB.*'

728. In the course of this Review, we have received representations from a number of HBOS senior management and Board members pointing to KPMG reports which found that the impairment

(167) This is however changing and, with effect from 1 January 2018, IFRS will require firms to use an 'expected credit loss' model to determine loan impairment provisions.
(168) By 'business' functions we mean the sales people, deal-makers, and relationship managers; as distinct from the Risk Functions.

provisions were within 'the acceptable range'. It was of course the responsibility of the firm, its Board and its senior management (rather than the auditor) to assess impairments correctly and to make appropriate provisions. It is no answer to point to sign-off by the auditor, and in fact, as set out later in this section, several of the reports warned that the provisions for Corporate Division were 'at the lower end of' or 'just within' the acceptable range.

729. HBOS's Corporate Division classified its loans into ten risk categories, with 'one' representing the least risk and 'ten' the greatest.

- The firm classified categories one to seven as the 'good book'. The 'bad book' comprised categories eight, nine and ten: category eight labelled 'high-risk'; category nine labelled 'impaired-no-loss'; and category ten labelled 'impaired-with-loss'.

- Specific provisions were only made against items in category ten.

- In addition to provisions on loans individually identified as impaired-with-loss, HBOS set aside a collective provision as an additional contingency for losses likely to be in the loan book but not yet individually identified.

730. During the Review Period, KPMG directly and independently assessed loans in the 'bad book' (including sampling the category eight 'high risk' loans, i.e. loans which were in the 'bad book' but not yet classified as impaired) and carried out testing to try to ensure timely recognition of specific impairments and to validate the modelling of the collective provision. In relation to the 'good book' (categories one to seven), KPMG reviewed the controls and reviewed the testing carried out by various HBOS risk functions (for example reviewing the credit reviews carried out by HBOS Group Risk). This approach changed in late 2008. However, HBOS would have been aware that throughout the Review Period KPMG did not directly review loans in the good book to assess whether they were correctly assessed and categorised. This is significant because, as set out in paragraph 746 below, the Corporate Division had not been properly re-categorising its loans into the 'bad book' when they became distressed.

731. A summary of the emergence of Corporate Division's impairments is set out below. There is little of significance before 2006, so our summary starts there.

2.11.2 2006

732. For the year ending 31 December 2006, the HBOS's Annual Report and Accounts (published in February 2007) showed a profit before tax of £5.7 billion. The Group impairment charge for losses on loans was £1.7 billion.(169) The executive summary of KPMG's 2006 year-end audit report to Group dated 14 February 2007 stated:

> '*there is no apparent trend towards over or under prudency. … There have been no significant changes to the Group's provisioning methodologies and where changes have been made they are improvements*'.
>
> '*In the Corporate Division at the end of 2005 there were still some uncertainties and nervousness regarding the adoption of IFRS which led to a prudent basis being adopted in several areas. These matters have now been resolved and have led to a catch up of income being booked in 2006. Nevertheless, there remains considerable prudence in several areas of Corporate's 2006 closing balance sheet*'.

(169) The figure for total impairment charge was £1.8 billion.

733. The 2006 year-end audit report to the Group also noted that both KPMG and Group Risk had separately sample-reviewed loans in the Corporate 'bad book'. KPMG reported that there were '*no major differences*' in the conclusions of the two reviews. The report also noted that the collective provision balance(170) had decreased as a percentage of the good book (from 18.7 bps to 15.8 bps).

734. KPMG's report on 2006 year-end audit findings to the Corporate Division's Risk Control Committee (RCC) dated 15 February 2007 noted that Corporate's investment portfolio valuations were conservative. It also reported the outcome of an exercise to benchmark the division's method of calculating its collective provision against the methods used by other banks. The benchmarking exercise identified two areas where the Corporate Division's methodology was different from that used by other banks in the commercial lending sector:

- distressed Corporate loans which were assessed by HBOS as requiring no individual provision (the 'impaired-no-loss' category) were not then included in the calculations for the collective provision; and

- Corporate used an 'emergence period' of four months, which KPMG advised was '*at the lower end of the range, with other banks using periods of up to twelve months'.*

Overall, the report to the Corporate RCC noted that KPMG's ultimate view of the adequacy of provisions was assessed at a Group-wide level, and concluded that Corporate provisions were consistent with applicable standards (IFRS) and that there were no significant issues to report to Group.

2.11.3 2007

735. By July 2007, Corporate impairments were starting to grow and coverage ratios starting to fall, with the Corporate Division placing increasing reliance on cyclically-sensitive areas such as collateral values and management's judgement. In its 2007 interim review, KPMG reported the following to both the Corporate RCC and to the Group Audit Committee:

> *'Credit Provisioning: a number of significant indicators have deteriorated over the half year, indicating a reduction in credit quality. … During the period impaired loans have increased significantly, while provisioning has not increased at the same rate. This has resulted in the level of provisioning as a percentage of impaired assets with loss decreasing from 63% at the year end to 49% as at 30 June 2007. While the level of impaired assets has increased management are of the opinion that there is sufficient security coverage or enterprise value in the Impaired-With-Loss book, such that the required level of recoveries will be made'.*

The report to the Group Audit Committee made it clear that the views about the adequacy of security were the views of Corporate senior management.

736. The meeting of the Group Audit Committee on 27 July 2007 noted that the Group interim results *'contained some of the more difficult audit and disclosure judgments since the merger in 2001'. 'The two principal issues at the interims were in respect of banking charges and unsecured provisions in Retail'.* The meeting also identified the Corporate control failure in one of HBOS's regional offices *'as being of significant concern since it indicated that the Division is reliant on detective processes to identify such failures. A more pro-active approach to controls is required. It also suggests that there has been sub-optimal investment in IT security/support since merger'.* The meeting minutes also record that: *'In Corporate, KPMG reported that there was still some way to*

(170) The balance sheet figure as distinct from the collective provision impairment charge.

go on IFRS appropriate valuations. There remains significant prudence in some areas of Corporate's half year balance sheet – such as valuation of the equity investments, continued provisions for legal uncertainties on sales of investments and deferral of the remainder of the JV investment property revaluation uplift. This will be a reporting issue for consideration at the full year'.

737. Therefore, in July 2007 the picture in relation to Corporate impairments and provisions was a mixed one: some indicators of prudence in relation to the valuation of investment securities, but an overall message of significant increase in impaired loans without an equivalent increase in provisions to cover those exposures.

738. The failure of Northern Rock in September 2007 was a major shock to the UK financial system, making headline news and leading to the first UK 'bank run' in many decades. At that point, Northern Rock was the most significant casualty of what was still being referred to as the 'credit crunch' – a reference to the contraction of the wholesale interbank lending market. There was little indication that the credit crunch would deepen into a global financial crisis of the scale which subsequently emerged. There were, however, indicators that the economy was starting to slow down, particularly in commercial property development – a sector to which HBOS's Corporate Division was heavily exposed.

739. At year-end 2007, the Corporate Division had identified impaired loans of £3.2 billion(171), almost double the level at year-end 2006. However, despite this substantial increase in impaired loans, provisions only marginally increased in absolute terms from £0.7 billion to £0.8 billion, which was actually a decrease in the level of provisioning relative to total lending. The explanation given for the increase in impairment numbers was the firm's decision to adopt a different definition of 'default' under Basel II (see below for more details).

740. Internally, the Corporate Division's High Risk and Impaired Assets Report explained that the 'impaired-no-loss' balance had increased due to the adoption of the more stringent Basel II definition of default (90 days past due). KPMG noted in its February 2008 report to the Corporate RCC that this '*should not necessarily be considered reflective of underlying credit quality, but rather reflects the fact that the significant amount of work that the Division has completed throughout the year in relation to Basle 2* [sic]'. A single exposure of around £500 million represented about a third of this higher 'impaired no loss' balance. A case-study of the provisioning decisions in relation to this customer ('AM1') is set out in Box 2.7 below. KPMG has told this Review that it had to push HBOS to re-categorise the AM1 loan from 'high risk' into 'impaired' for the 2007 year-end. In 2007, new disclosure standards for the classification of stressed assets had been introduced;(172) in interview, KPMG said: '*HBOS weren't particularly good at those sort of disclosures, so we found that we had to push and correct quite often*'. The division agreed to the re-categorisation of AM1, but maintained that no provision was required because a full recovery would be made. The loan subsequently incurred significant losses. The AM1 case-study is one of many examples which this Review could have chosen to illustrate the Corporate Division's optimistic judgements that their 'workout solutions' would result in a full recovery despite significant objective indicators of impairment.

741. Following the year-end credit challenge meetings with KPMG, the Corporate Division increased its proposed provisions by £60-70 million. KPMG's year-end report to the Corporate RCC stated that: '*credit provisions overall are less conservatively positioned than in recent years*' and that '*a higher proportion of individual impairment provisions are towards the lower end of the expected range*'.(173) In relation to a number of accounts, management's assessment was seen as optimistic by an order of £50-100 million given the prevailing market conditions, but still within the acceptable range. In relation to the Corporate Division's collective provision, KPMG

(171) HBOS expected to incur an impairment loss of £0.8 billion on this £3.2 billion portfolio of impaired loans.
(172) By IFRS 7.
(173) KPMG 2007 year-end Report to the Corporate Risk Control Committee, 20 February 2008.

considered the provision to be, overall, at the more aggressive (i.e. low) end of the range of possible outcomes. KPMG based this conclusion on a number of judgemental factors, notably: the use by HBOS of an emergence period of four months which was at the lower end of the range compared to peers; the exclusion of loans that had been individually assessed as 'impaired-no-loss' from the collective modelling calculation (unlike a number of peers)(174); and the absence of any overall adjustment to take account of the deteriorating economic conditions.

742. As with previous audits, for the 2007 year-end, in relation to the 'bad book' KPMG directly and independently assessed the loans (including sampling the category eight 'high risk' loans) and carried out testing to try to ensure timely recognition of specific impairments and to validate the modelling of the collective provision. In relation to the 'good book' (categories one to seven) KPMG reviewed the Corporate Division's controls and reviewed the testing which had been carried out by various HBOS risk functions – for example, reviewing the credit reviews carried out by HBOS Group Risk.

743. As noted previously, a significant control failing had been identified earlier in the year at one of HBOS's regional offices. KPMG's 2007 year-end audit of Corporate highlighted a concern that the large impairment charge resulting from that failure – £266 million – created pressure to keep other provisions low. KPMG reported to HBOS in February 2008 that:

> '*The additional provisioning resulting from the* [Branch B] *portfolio has accounted for 40% of the total individual provisioning charge and has clearly put pressure on this balance. In some cases, we believe this has resulted in provisions being at the lower end of an acceptable range. We have noted the reducing cover of the collective provision. Taken together, we consider that the impact of* [Branch B] *and deteriorating market conditions have resulted in less conservative positioning of overall provisions albeit that they remain within a justifiable range*'.

744. Decisions on provisions necessarily involve the exercise of judgement. The Review notes the view taken by KPMG, as recorded in the minutes of the Corporate RCC session on 20 February 2008, that: *'loss rates within the portfolio had increased by 17% from 52 bps to 61 bps, the total charged to the income statement increasing from £429m in 2006 to £602m. This was primarily due to the individual impairment charge, where the* [provision relating to a significant control failing in one of HBOS's regional offices] *had increased to £266m. <u>This placed pressure on the individual impairment provisions, and KPMG highlighted that this may have contributed to less conservative provisions on other accounts'</u>.* [emphasis added] This appears to suggest that Corporate might have been managing provisions to a budget – that the unexpected provision arising from the Branch B incident resulted in pressure to keep provisions low elsewhere in the division.

745. The KPMG report also noted that: *'Had* [Corporate] *asset growth been closer to plan, the deteriorating trend in impaired assets as a percentage of total advances and in the loss rate would have worsened and, in contrast, overall measures of provision coverage would have been increased'*.

2.11.4 2008

746. In February 2008, HBOS's Corporate Risk Assurance Team carried out a review of credit risk. The subsequent report included a finding (rated amber), the underlying detail of which questioned whether impaired assets were migrating in a timely fashion from the 'good book' into high risk.

(174) Many firms included 'impaired-no-loss' loans in their calculations of the collective provision. HBOS did not. The collective provision is designed to capture losses *likely* to exist in the wider loan portfolio where those losses have not been individually assessed and provided for. HBOS adopted a particular interpretation of the accountancy rules which went as follows: where there is evidence that a particular loan is impaired, it should be included within the specific provisions; once that has happened, it should not be included in the 'collective provision'; However, where HBOS calculated the specific loss at zero (including because there was incomplete information to calculate the likely loss or because HBOS believed it could devise an exit strategy without loss) it did not then include the loan in the calculation of the collective provision, arguing that since a specific provision had been calculated (albeit zero), it would be inappropriate to also include the loan in the calculation of the collective provision. As a result, these impaired loans were not accounted for in either the specific or collective provisions.

The Risk Assurance report noted that two senior people had informed the team that: '*cases are consistently being flagged to High Risk at too late a point in their life cycle to allow* [the] *Impaired Assets* [team] *to have any meaningful input'. Overall, the report was 'badged Red to reflect both the limited progress around actions previously raised and our view that a more robust control environment requires to be established*'. The report noted that the red badging reflected evident gaps in the systems and processes in place rather than the application of those processes by the Impaired Assets team. This February 2008 report was not shared with KPMG.(175)

747. During this period, the Corporate Division demonstrated a significant degree of optimism regarding both the credit quality of the portfolio and the likelihood of exiting without loss when the loans were recognised as impaired. This impacted directly on the decisions that were taken as to the appropriate level of provisioning.

748. In April 2008, KPMG presented its review of interim profits for 2008 Q1 to the HBOS Group Audit Committee. At this stage, although KPMG was highlighting problem loans and was questioning – and in some cases challenging quite hard – whether additional provisions were needed, KPMG was not conducting any independent testing as this was not year-end audit work. KPMG's report noted that market turbulence had worsened and that this was being most widely felt in Treasury. In relation to Corporate, the executive summary of KPMG's report noted the continued growth of the syndicated loan portfolio due to the illiquid markets and inability to sell down: '*Management continue to believe that no impairment provision is required and have reiterated that there is no intention to sell at a discount.*' In relation to credit quality across the Group it stated:

> '*The credit market continues to show stress across the group which is impacting on the general quality of the credit portfolios. … In Corporate there are increased instances of customers breaching covenants and in Australia there is an increase in impaired assets. … while Corporate has booked an additional charge; this is, in KPMG's view in part a catch up from 2007. In addition there are two large impaired accounts* [AM1] *and* [AM2] *for which provisions are negligible*'.

On individual Corporate provisions, the charge for impairment losses to end-Q1 was £160 million, of which £20 million was a 'central accrual' not allocated to specific loans. KPMG's report stated:

> '*In our view an element of this provision relates to a catch-up from 2007 on certain exposures that were impaired-with-loss at the year-end'.*
>
> *'We reported at the year-end that on some of the* [accounts] *we concluded that a less optimistic view of future earnings or exit multiples would have been appropriate, given current market conditions and generally gloomier economic outlook. This resulted in some provisions which were at the lower end of the range of acceptable values. Having completed our review work, we continue to hold this view with regard to certain specific* [accounts]. *However we note that the additional* [£20m] *accrual applied centrally does help to address this point, together with the uncertainty provision discussed on the next page*'.

For the collective provision, no impairment charge was booked for 2008 Q1 and therefore the balance sheet provision had not increased since year-end 2007. KPMG noted that:

> '*Management has concluded that the year-end provision of £130m should not be adjusted. … In this context, <u>we are concerned that the exclusion of impaired-no-loss accounts from the methodology will outweigh those elements of prudency in the model in a deteriorating credit environment</u>. We have discussed this with management and advised that our expectation is that the collective provision will be higher at half year, with the management overlay either*

(175) It appears that the issue of slow migration/misclassification of distressed loans was known to KPMG by 2008 Q3 (*see paragraph 761*).

2

significantly reduced or robustly justified, given the current market conditions. We note that the adjustment referred to below [the £70 million uncertainty provision] *provides some comfort in this respect'.* [emphasis added]

'Uncertainty Provision: Management has booked a provision accrual of £70m to take into account the uncertainties in the portfolio and in the provisioning, as discussed in the sections above. We expect management to undertake a review before half year and allocate this to specific loans or investments'.

749. KPMG's minutes of its separate meeting with Group Finance the same month noted that KPMG advised Group Finance that the Corporate provisions were *'at the low end of the acceptable range'*.

750. Despite the clear warnings(176) given by KPMG in the Q1 interim review, there was limited evidence of a positive response from the Group. There is no indication from the minutes of a Group Audit Committee meeting on 23 April 2008 of substantive discussion or challenge by the Group Audit Committee on provisioning practices. The minutes did, however, record the HBOS FD's view that the HBOS Group Q1 Forecast '*had been extraordinarily difficult to produce in the midst of such uncertainty and global financial market chaos. Numerous assumptions have had to be made, not least concerning the availability and cost of funding… There is therefore a greater degree of risk attached to this Q1F than would historically be the case*'.

751. At the end of April 2008, HBOS announced that it would be seeking to raise £4 billion from its shareholders by way of a rights issue. KPMG was asked to carry out certain specific work to support the rights issue. This work was to determine whether there had been any 'significant change' since the 2007 year-end. This was referred to as the '*No Significant Change*' work. This involved a review of the *'movements in profit and shareholders' equity of HBOS Group for the five months to 31 May 2008'*. The procedures carried out by KPMG did not *'constitute an audit or review made in accordance with any generally accepted auditing standards'*. KPMG was not instructed to carry out any independent testing of the information provided by HBOS.

752. KPMG's work had focused on '*the most significant divisions, and those with accounting areas involving the most significant estimation uncertainty. These are: Retail, Corporate, Treasury, I&I (FS), Australian and Group*'. KPMG reported to the firm that:

'other than as disclosed in the schedule attached and in the prospectus, nothing has come to our attention which causes us to believe that…

(a) there has been any significant Change in the Financial Position between 31 December 2007 and the Cut-off date; or

(b) there has been any significant Change in the Trading Position since 31 December 2007 to the Cut-off date'.

753. KPMG advised the Group Audit Committee on 16 June 2008 that, although Corporate had increased the collective provision by £25 million on KPMG's recommendation, Corporate provisions were still light.(177) This was because the £25 million uplift was in effect a '*catch up on the* [2007] *year end position*' and did not take account of the deteriorating economic environment. As a result, KPMG had expected the collective provision to be '*significantly higher*'. The view which KPMG expressed to the Group Audit Committee was that, overall, while

(176) Warnings about the growing inability to sell off loans, the increasing covenant breaches, the growing signs of stress in the credit market, the negligible provisions on some large impaired accounts, the methodology used to calculate the collective provision, and the conclusion that Corporate provisions were at the low end of the acceptable range.
(177) *See paragraph 769 below.*

remaining within acceptable ranges, the level of prudence in Corporate provisioning had deteriorated.

754. A month later came KPMG's review of interim profits for 2008 H1. In Corporate, £56 million additional provisions had been booked in the six months to 30 June 2008 to keep pace with the increasing collective provisioning model. However, KPMG did not consider that this reduced the gap. Combined with concerns on the individual provisioning, KPMG advised the firm that it considered that:

> '*the overall provisions in Corporate are light. This view is not dependent on large shortfalls on one or more exposures; rather it is due to a combination of factors – the low/slow individual provisions, the provisions tracking below the model and the recent adverse news flows. We anticipate a significant increase in the provision in the second-half of the year*'.

755. The minutes of a Corporate RCC meeting on 21 July 2008 noted the differing views between KPMG and the Corporate Division on provisioning: '*Given the increase, since year end, in the difference between KPMG and management's view of the adequacy of provision levels it was agreed that, whilst acknowledging the difficulties the current environment caused in agreeing valuations, more work should be undertaken to look specifically at the differences in opinion prior to year end*'. Notwithstanding the differences in opinion, KPMG still viewed the relationship with Corporate management as good. In a private session with the Group Audit Committee on 25 July 2008 without management present, KPMG '*reiterated the good liaison they had with senior management in Corporate and that overall a realistic approach* [to the Group position] *was being maintained*'.

756. KPMG's ultimate assessment of the adequacy of provisions was, however, made at Group level. The interim report to Group stated: '*Overall, we are satisfied that the light provisions in Corporate are covered by Retail unrecognised contingencies*[178] *and the potential effective interest rate (EIR) asset uplift* [£97.7 million].' In effect, KPMG accepted HBOS off-setting some prudence in the Retail book against less prudence in the Corporate book.

757. At a meeting on 25 July 2008, the Group Audit Committee endorsed the approach adopted in 2008 H1 of drawing on contingency in Retail provisions to offset insufficient prudence in Corporate provisions, rather than encouraging Corporate to provision at a more prudent level. The minutes of that meeting noted: '*The Chairman then summarised the discussions and report. The Group was seeking to trade through challenging and uncertain times. Many of the judgements and valuations being made at the Interims were particularly difficult. The dialogue between KPMG and management had been open and transparent which had helped everyone come to reasonable answers. The main concerns remain in Corporate and Treasury, but KPMG were content with the overall outcome by relying on evidence of some prudence in Retail to offset light provisions in Corporate. The Audit Committee agreed*'.

758. In summary, in the period leading up to September 2008, HBOS was given a number of warnings about Corporate's approach to provisioning and warnings that Corporate provisions were towards the bottom of the acceptable range and that with the economic situation deteriorating, even higher provisioning was to be expected. There is no evidence that the Group Audit Committee or the Board acted on these warnings, for example by challenging the culture and attitude of the Corporate Division. Similarly, there is no evidence in the minutes of the Corporate RCC meeting on 21 July 2008 that the timeliness of provisioning was recognised as an issue or that there was any consideration of whether action should be taken. Overall, the focus seems to have been on the fact that provision levels were found to be 'within' the acceptable

(178) Unrecognised contingencies in Retail: this appears to be a reference to the fact that HBOS had developed new provisioning models. HBOS was operating its existing and its new models in parallel while the new models were being refined. The new models were producing lower figures than the existing models: however HBOS chose not to reduce their provisions to these lower figures, but continued to hold provisions at a slightly higher level.

range, rather than whether they were at a prudent position within that range given the deteriorating market conditions.

759. Lehman Brothers failed on 15 September 2008, followed two days later by the announcement of a possible merger of HBOS with Lloyds TSB. Market conditions had been on a downward trend since September 2007 (see Section 2.2.3, '*The onset of the financial crisis*'). However, the failure of Lehman Brothers was a significant watershed event after which general market conditions and HBOS's own position began to deteriorate very rapidly. After this date, there was a general recognition (including by HBOS and KPMG) that the financial dislocation would not be temporary. On 26 September, Washington Mutual (a large 'savings and loan' bank) failed in the USA. HBOS was an unsecured creditor of both Lehman Brothers and Washington Mutual. By the end of September, HBOS had estimated its impairment as £600 million for these two exposures alone. On 1 October, HBOS sought ELA from the Bank of England, which for the purposes of this Review is defined as the point of failure of HBOS. Most of the impairment losses on loans and other assets held by HBOS emerged and were recognised in the HBOS accounts after this date.

2008 Q4

760. The cumulative HBOS Group impairment charge booked for end-Q2 2008 was £1.3 billion, by full year 2008 it was £12.1 billion. Within those figures, the impairment charge for Corporate was under £0.6 billion for the end of Q2, £1.7 billion for Q3, but for year-end 2008 was £6.6 billion. The last few months of 2008 are therefore an important part of the story of the HBOS impairment levels, even though they fall after the date on which the firm received ELA.

761. In the Corporate Division, the number of distressed loans being referred from the 'good book' to the 'High Risk and Impaired Assets' (HRIA) team began to increase dramatically in Q4 as the real economy entered recession, and in particular as property developers began to default. However, the division's business functions or 'front office' remained reluctant to re-categorise loans from the good book to the 'bad' book' with the result that even the increasing number of loans moving to the HRIA team may have been under-stated. The speed of deterioration was overwhelming and outpaced the resources of the HRIA team to fully process the distressed loans being referred to it and to allocate them between 'high risk', 'impaired-no-loss', or 'impaired-with-loss': only this latter category attracted a provision. Once in the 'bad book' there was continuing reluctance by the 'business functions' to acknowledge that the distressed loan might result in a loss, with the senior management continuing to put its faith in the ability of its team to implement a successful 'workout solution' for recovery. Two further factors had a potential impact on the accuracy of the figures for this 'impaired-with-loss' category: the reluctance of the firm to recognise provisions until full information was available and an optimistic approach to calculating the likely loss (and therefore the provisions to be made). In some cases, what this meant was that even if the firm acknowledged that the loan was distressed, and that a loss would be incurred, if it did not yet have full information (for example an up to date valuation) it would book the provision as zero.

762. As the financial crisis accelerated in 2008 Q4, a number of incidents seem to illustrate a material difference between the views of HBOS senior management and those who were reviewing the underlying asset quality – be it Corporate Risk, Group Credit Risk or KPMG. We have received representations from several parties that there was no such difference of opinion. However, the balance of evidence given to this Review – both contemporaneous documentary evidence and oral evidence – indicates that there was a significant gap between the continuing optimism of the 'front office' or 'business-side' (including senior management) and the more pessimistic views of Corporate Risk, some parts of Group Risk and the external auditors.

763. One of the many activities that HBOS senior management was focused on during the turbulence of October 2008, was finalising the Q3 interim results to end-September 2008 and preparing an

Interim Management Statement for publication. Events in the market were moving at an exceptional pace. The Q3 results, and KPMG's report on the Q3 results, would be a significant input into the proposed merger/takeover. In addition, the UK Government announced a bank stabilisation and recapitalisation programme on 8 October 2008. For all of these reasons, the Q3 figures took on a significance not normally associated with Q3 results, and the process of deciding a figure for Q3 impairment losses and provisions appears to have been intense. Initially, the business-side of the firm continued to advocate the traditional HBOS approach of 'work-out solutions'. However, the HBOS Risk functions and the firm's external auditors were increasingly sceptical about the feasibility of positive outcomes given the continuing deterioration of the market. As the volume of Corporate Division loans moving into high risk and impaired increased and the materiality of the potential impairment losses began to increase, Group senior management became more intensively engaged in the process for deciding impairments. Perhaps unsurprisingly given the febrile environment in late 2008, with so much else going on, the audit trail for meetings and decisions in relation to impairment figures is not complete and we have received very different accounts of meetings, discussions and decisions in relation to impairments. We have been told that as the Corporate Risk function (Impaired Assets team) was finalising its proposed figures for end-September 2008 and its forecasts for the likely losses at full year, it encountered a higher than usual level of challenge from the 'business' functions. Senior management have told us that their increased level of engagement was entirely appropriate given the increasing materiality of the Corporate impairment numbers.

764. The Corporate Chief Risk Officer (CRO) has told us that in early October 2008 the Corporate Risk function circulated draft figures forecasting a range for year-end impairment losses ranging from £1.7 billion' best-case' to £3.6 billion 'worst-case' and recommending that the division plan on the basis of a £2.6 billion 'mid-case' forecast. Some others at Group level have said that they were never informed of a £3.6 billion forecast range and that the £2.6 billion was not the figure recommended by Risk at the meeting. Instead their recollection is that Risk put forward a £1.7 billion forecast, with a potential £1 billion 'downside' – therefore a range of £1.7 billion to £2.7 billion.(179) An urgent meeting was called on the morning of Sunday 5 October 2008 attended by the Corporate Risk function and representatives of both Corporate and Group senior management to go through the impairment forecasts on a loan by loan basis. There are no minutes for this meeting and the Head of Group Credit Risk at HBOS has told this Review that he was *'completely excluded'* from all decisions about Corporate impairments because of the concerns he had previously raised. In describing the meeting, the Corporate CRO said *'it was a very one-way challenge … We were never challenged that perhaps our number was too low, we were always challenged that our number was too high.'* The outcome of that meeting was that the Corporate Division chose to proceed with the £1.7 billion forecast for year end.

765. A few days after the 5 October meeting, the Head of Group Credit Risk was informed that the usual quarterly trends paper, *Key Credit Trends*, produced by his team would not be going to the HBOS ExCo or the HBOS Board because of '*everything else going on*'. The Head of Group Credit Risk was concerned that ExCo and the Board were not being shown a realistic picture of the possible losses. In interview, the Head of Group Credit Risk told this Review that he had raised his concerns about impairment levels over the course of several weeks to the Group Risk Director and the Group FD. He then escalated his concerns separately to a HBOS executive Board member and to a non-executive Board member. In an email of 13 October 2008 to the executive Board member, he set out his view that the year-end forecast for Corporate should be £2.2 billion or £2.7 billion (rather than the £1.7 billion proposed) and he stated that he had raised these concerns with the Group Risk Director and the Group FD. In the email, the Head of Group Credit Risk informed the Board member that his concerns were shared by the Corporate

(179) There is documentary evidence showing a £1.7 billion 'absolute best case', with a potential £1 billion downside – therefore a range of £1.7 billion to £2.7 billion. There is also a PowerPoint slide document showing year-end impairment losses in a range from £1.7 billion (best case), £2.7 billion (mid case), and £3.6 billion (worst case) with the statement: '*Middle assumptions reflect our prudent banker case*'. The copy provided to this Review is annotated: '*Circulated to the Corporate Board*' but is undated and from the enquiries which we have undertaken we have not been unable to establish when it was circulated. The Corporate CRO has stated that it was circulated to the Corporate Board and that the £2.6 billion was the figure which was recommended.

CRO. This Review has been unable to find any evidence or audit trail showing that the concerns of the Head of Group Credit Risk were discussed at the Board. On the same day, 13 October 2008, HBOS issued an RNS announcement which stated:

'Since the announcement of the Interim Results for the six months ended 30 June 2008, market conditions have deteriorated significantly. Underlying profitability is therefore now being impacted by a significant deterioration in credit conditions and falling property prices with associated increased provisioning in both the Retail and Corporate businesses. In addition, profitability is expected to be adversely affected by fair value adjustments and impairments to the Treasury portfolio and by the impact of increased funding costs.

HBOS now expects these factors to impact substantially on the management's expectations of the underlying results for 2008. In addition, as previously announced HBOS will report a loss of £690m on the sale of BankWest.

Notwithstanding the current difficult market conditions, HBOS's Insurance & Investment business is performing satisfactorily and is expected to continue to benefit from its close affiliation to the UK Retail savings business. A full trading update will be provided in the Interim Management Statement to be released shortly before publication of the prospectus relating to the equity placing'.

766. Based on the outcome of the Sunday 5 October meeting, a number of discussions were held with the external auditor in an effort to settle the impairment figure for the month of September, which in turn would determine the Q3 year-to-date (YTD) impairment figure for publication. The firm proposed a Corporate impairment charge for the month of September of just under £0.5 billion, which would have brought the cumulative Q3 YTD impairment charge to just under £1.1 billion(180). A Q3 actual of £1.1 billion would have been in line with the firm's proposed year-end Corporate impairment forecast of £1.7 billion. Contemporaneous documentary evidence obtained from HBOS indicates that during these discussions about the Q3 impairments KPMG described the forecast outcomes as '*universally optimistic*'. KPMG provided HBOS with a detailed schedule analysing the fifteen largest single exposures which were driving KPMG's view of actual impairments. KPMG proposed a September impairment charge of £1.6 billion (instead of the £0.5 billion proposed by the firm) which would have brought the Q3 YTD impairment to £2.2 billion. Intense discussions ensued between the firm and KPMG including a meeting in which the firm fielded a number of business and risk representatives. The express purpose of the meeting appears to have been to provide challenge to KPMG's proposed impairment charge for September, including to try to persuade KPMG to accept the firm's explanations as to why there should be no provision booked in September for these fifteen impaired loans, when most of the borrowers were already in administration or restructuring. The eventual outcome was that the provision booked for the month of September was £1.1 billion – not quite the full £1.6 billion proposed by KPMG but still £0.7 billion higher than the figure proposed by the firm. This brought the Q3 YTD corporate impairment figure to £1.7 billion.(181) For some key individual impairments, the firm did not agree to take the provision suggested by KPMG for the end Q3 figure – some of these would subsequently be taken in October, and some were not agreed until year-end. For a case study of one example, see Box 2.7 below.

(180) The Corporate impairment figure for YTD to the end of August 2008 stood at just over £0.6 billion.
(181) Once the year-to-date provisions as at the end-September 2008 had been booked at £1.7 billion, it was no longer tenable to continue to suggest that the year-end figure would be £1.7 billion. The forecast for year-end Group impairments was then increased to £2.2billion (see *paragraph 771*).

Box 2.7: 'AM1' individual provisioning case study

Customer AM1 was a property development company owned by an overseas entrepreneur. The company was a long-standing client of HBOS. AM1 was a significant exposure for HBOS, involving debt facilities of approximately £560 million.

AM1 experienced financial problems at the time of the onset of the US sub-prime housing downturn. HBOS experienced difficulties in managing the situation as the security for the facility included development assets based in the US. Despite the difficulties and despite input from the High Risk team, it was not formally transferred to High Risk until January 2008 after AM1 failed to meet a facility repayment due on 31 December 2007. In February 2008, at KPMG's insistence, AM1 was reclassified (for year end 2007) as Impaired. At this point, and throughout 2008, HBOS maintained in its discussions with KPMG that HBOS would not suffer a loss. KPMG reported to the Group Audit Committee on 13 June 2008 that: '*Given that the relationship with AM1 has improved, and there is genuine interest in the assets, management do not consider it necessary to make a provision.* [emphasis added] *We concur this is acceptable, but at the less prudent end*'. In July 2008, KPMG reported to the Group Audit Committee that '*significant downside risk exists on* [AM1]'.

In October 2008, in the meetings to discuss the provisions for end-September 2008 KPMG recommended a provision of £100 million for AM1. By this time, AM1 had been in default for nine months, HBOS and the customer were in a legal dispute, meaning that a workout plan could not be implemented. However HBOS maintained that there would be no loss and declined to make a provision for the loan. KPMG's Q3/No Significant Change report to the Group Audit Committee dated 23 October 2008 stated: '*we consider that significant downside risk remains on exposures that have been identified as impaired. In a number of cases management's view remains at the optimistic end of the range… The significant connections that give us greatest concern are* [AM1 plus two others]'.

HBOS senior management maintained their position and no provision was made for AM1 until December 2008. The 2008 year-end HBOS financial statements contained an impairment charge of £175 million for AM1.

767. Once the September figure was settled, KPMG was able to produce its interim Q3 report. The Q3 report which KMPG produced was entitled *Summary of results with respect to 'No Significant Change' work*. This was presented to both the HBOS Group Audit Committee and the HBOS Board. The basis of the document is set out as follows:

> '*1.1 Introduction: This document highlights the most significant subjective areas and presents the key matters arising from our work related to the movements in profit and shareholders' equity of HBOS Group for the nine months to 30 September 2008. Except where otherwise stated, this document reflects our position at 23 October 2008. Where necessary, an oral update will be provided to the Audit Committee at its meeting on 27 October 2008. All significant matters arising from our work have been discussed with HBOS divisional and Group management. As the governance structure around monthly management accounts, and therefore the 30 September 2008 figures, does not include Divisional RCC meetings, these findings have not been presented to Divisional RCCs.*
>
> *1.2 Background: One of the requirements of the prospectus and circular being prepared by Lloyds TSB for its proposed acquisition of HBOS is that HBOS provides an update to its financial and trading position. It is envisaged that this will be taken from HBOS' Interim Management Statement. In addition, the sponsors request us to provide negative comfort over those statements in the form of comfort letters. Our work comprises agreed upon procedures, the findings from which are included in our comfort letter. These agreed upon procedures do not*

constitute a review or an audit under International Standards and are not designed to provide a true and fair audit opinion. Accordingly, the scope of our work has been limited as is described in section 1.3, and does not constitute a review or an audit'.

768. The executive summary section of the KPMG Q3 report stated:

'2.1 Quality of earnings and level of prudence
We have not identified any material 'hard' review differences during the course of our work. In line with recent reports we have prepared for the audit committee, we show below the key areas of subjectivity where there is a range of potential results. … It is important to recognise that in the current market uncertainty, together with the rapid deterioration in market confidence and lack of activity in both retail and commercial property markets, makes the estimation of the appropriate level of provisions hugely difficult.

2.2 Impact of current market conditions
The impact of the market turbulence over the past eight weeks on the global financial services industry has been unprecedented, resulting in a flurry of acquisition activity, government-sponsored assistance packages, and bankruptcies that only six months ago would have been considered a remote possibility. The key matters that we have been reporting to you throughout the 2008 year continue to impact HBOS, and indeed, in most cases have been exacerbated during these very volatile times. The key impacts for HBOS have been:

- *the collapse of Lehman's and breakup of Washington Mutual has resulted in £457m negative impact on Q3 results due to impairment losses in respect of AFS assets;*
- *although Treasury continues to be impacted primarily due to security valuation issues, some relief has been seen as a result of recent amendments to IFRS (IAS 39) which enable certain securities to be reclassified from the trading book to the AFS book. This has resulted in approx £800m of negative fair value adjustments that would have been recognised in the p&l during Q3 to be recognised in equity;*
- *in Corporate, exposures have moved rapidly to the high-risk and impaired categories, and due partially to the size of the average exposure, has resulted in a charge of £1.3bn in Q3 compared to £0.5bn for the first six months for specific and collective provisions;*
- *in retail the further decline in HPI and increase in impairments resulted in a charge of £0.5bn in Q3 compared to £0.7bn in the first six months;*
- *the impact of the fall of the Icelandic banks is expected to flow through in Q4; the total amount at risk is £165m;*
- *the significant increase in wholesale funding costs together with the outflow of retail and corporate deposits is putting pressure on the net interest margin.*

2.3 Corporate credit provisioning
Management's paper highlights the significant move of accounts into the high risk and impaired categories during Q3. It also sets out the major new provisions in the quarter. We have had lengthy discussions with management over the level of provisions at 30 September. There has been a significant increase in the collective provision to £0.5bn which we consider is appropriate to cover losses that exist but which have not yet been individually identified[182]*. Whilst there have also been significant additional individual provisions, overall we consider that management's*

(182) This is reference to the balance sheet provision, and not the impairment charge. The impairment charge is £0.4 billion, which when added to the specific provision charge of £1.3 billion gives the £1.7 billion total charge for Corporate for the year to September 2008.

view on some of the more significant cases is optimistic given the rapidly deteriorating economy, particularly in the housebuilding and real estate sector to which the Division is highly exposed.

We have therefore indicated on the chart above that an additional £200m could, in our view, be justified at 30 September.

2.4 Retail Credit Provisioning
As previously reported, Retail's provisions do not adjust for HPI data on a monthly basis, and in the current declining market this results in current model output for provisions that are below the required levels. However, we are comfortable with management's view that current contingencies within the secured and unsecured provisions adequately cover this impact.

…

2.10 Q4 outlook
We expect further significant provisions for both corporate and retail exposures in the last quarter of the year as economic conditions continue to deteriorate, further assets migrate to impaired and management fully determine the work-out strategy for impaired connections. More pressure may also arise on the corporate investment portfolio'.

769. The section on '*Credit Quality and Provisioning for Corporate*' stated:

'The speed at which assets have migrated to High Risk and Impaired has accelerated rapidly, resulting in an increase in this portfolio from £6,338m at 30 June 2008 to £9,569m at 30 September 2008. This makes up 8% of the total loans and advances. Impaired assets with loss as a % of total advances has nearly doubled from 1.8% at half year to 3.3% of the total book at 30 September 2008.

Since 30 June 2008 there has [sic] *been additional specific provision charges of £909m. Furthermore, in response to the deteriorating economic conditions management has increased the collective provision significantly by £343m. Individual provisions as a % of Impaired-with-loss accounts has increased from 35% as at 30 June 2008 to 40% as at 30 September 2008.*

Real estate, construction and housebuilders
Real estate lending across the asset classes represents c.50% of the total debt exposure in the Division. Within this the Division has c.£7bn (6% of total loans & advances) exposure to the construction, house-building and residential development sector, with significant exposures to [Corporate customers A, B, C, D, E, F and G].

Individual provisions
Individual provisions as at 30 September 2008 are £1,619m, with a charge to the income statement of £1,322m for the period.

£909m Individual provision charge was booked in the third quarter of the year. Major components of the charge are £254m for [customer H], *£100m for* [customer K] *and £89m charge for* [customer M]. *The significant increase in the provision charge this quarter is due to:*

– *rapid acceleration of accounts into impaired category;*

– *impact of the provisions of a number of significant individual connections;*

– *an element of catch-up from June, when we reported the provisioning cover as light.*

Notwithstanding the significant provisions taken this quarter, we consider that significant downside risk remains on exposures that have been identified as impaired. In a number of cases management's view remains at the optimistic end of the range, particularly under the discounting methodology applied to the estimated future cashflows as required by IAS 39. The significant connections that give us greatest concern are [AM1 & two others].

Collective provision
This quarter, the collective provision has been strengthened considerably by £346m, increasing the collective provision to £533m as at 30 September 2008. As a logic check, we would expect the collective provision to approximate to a 'normal' quarterly individual provision charge as it is running and projected to run. The increase during Q3 has achieved this. We look to the collective in part to also provide comfort over some of the large accounts on which we have commented. The model itself is being enhanced and will be further developed in Q4.

Provision summary
During the quarter to 30 September 2008 management has significantly increased individual and collective provisions; however this is against a background of a rapidly deteriorating economy, particularly in the housebuilder and real estate sectors to which the Division is highly exposed. Given the nature of the portfolio and concentration on some very high value exposures, the ultimate potential provisions required could be very wide ranging dependent on the outcome of individual large exposures. Management is performing further analysis on these accounts in Q4, and with the continued flow of accounts into high risk and impaired, we shall be carrying out further detailed work in this area as part of our year end audit'.

770. KPMG presented the Q3 paper to the HBOS Group Audit committee on 27 October 2008. The minutes of the meeting indicate that KPMG said that Corporate provisions had been increased after '*lengthy robust discussions with* [Corporate] *management over the level of provisions*', that KPMG would have been even more cautious, and that HBOS were '*just in the acceptable range'*.

771. At the HBOS Board meeting on 28 October 2008, the Board was informed that Group impairments were now forecast to be £4.4 billion at FY 2008. The increase was attributed to the losses on the sale of BankWest Australia, and the anticipated impairment losses on Corporate which were now forecast to be £2.2 billion, rather than the £1.2 billion which had been the full year forecast in June. The Board paper included an appendix entitled '*Corporate Portfolio Performance*' giving an explanation for the '*rapid deterioration*' in Corporate. It included the following:

'as the Board is aware, credit conditions in Corporate markets have been challenging for some time … The pace of deterioration has increased markedly over the last few months …

Not only are defaults rising significantly, but losses on those defaults are now expected to be higher. … we expect Corporate's performance to be significantly worse than our main competitors … driven by our high exposure to real estate … holdings of risk capital … in the JV's and ISAF businesses, and certain concentrations in troubled single names across the Division. … commencing in Q2, the picture began to change most noticeably in the housebuilder sector … This shift and similar deterioration most noticeably in other property sectors led to stressed assets beginning to rise from May 2008 with a significant acceleration in the third quarter. ... These trends are influenced by a number of large single credits … either exposed to the housebuilder sector or with higher leverage than current performance can support. …'

'4. Why have forecast losses increased so quickly:

Housebuilders:

At the interims, the sector showed "a sharp downturn in volumes, but were typically in compliance with covenants and offered no objective evidence of impairment requirement. … many of these companies are now in breach or close to breaching covenants and/or entering into restructuring discussions with their banks'.

…

'Deterioration of impaired cases:

Corporate has a track record of working with customers to seek to maximise recoveries on impaired assets through orderly restructurings or turnarounds… [but] *… there are virtually no buyers for many assets except at deeply distressed values. We have increased our provisions against a number of these cases … These additional provisions are estimated to be circa £0.3bn'.*

'Collective Provision. Following discussions with KPMG it has been agreed to increase our collective provision by £345m to £532m in Q3. This reflects the more difficult economic environment, provides some contingency against a number of the high risk cases where further information is being sought which may lead to higher individual impairments'.

772. On 3 November 2008, HBOS published an Interim Management Statement which included the following[183]:

'Group Overview

The Group is operating in difficult market conditions. Relative to 2007, in the nine months to the end of September 2008, profitability has been impacted by higher impairments, negative fair value adjustments to the Treasury Portfolio, the sale of BankWest and short term fluctuations in investment returns. However, despite higher funding costs, net interest income from our banking businesses has increased and our Insurance & Investment business has made a good contribution. This, together with tight Group cost control, demonstrates the strength of our core business.

HBOS's capital ratios benefit from the proceeds of the Rights Issue and capitalisation of the interim dividend for 2008. As at 30 September 2008, our Tier 1 ratio was 8.1% and our Core Tier 1 ratio 6.0%.

The proposed placing of £8.5bn additional equity and £3bn 12% preference shares in January 2009, subject to shareholder approval, would be equivalent to an increase in the relevant capital ratios at that time of some 340bps for Tier 1 and 250bps for Core Tier 1. Most importantly, this injection of capital is linked to the provision of Government guarantees for certain wholesale funding issuance. This materially strengthens the Group's funding position following deposit outflows in September and in the first half of October, which have now slowed significantly.

The proposed acquisition of the HBOS Group by Lloyds TSB is proceeding according to plan. As announced today, the Lloyds TSB meeting to approve the acquisition of HBOS will be held on 19 November 2008. HBOS expects to hold a General Meeting to approve the acquisition by Lloyds TSB, and the placing of equity and preference shares, in December 2008. Subject to shareholder approval and legal and regulatory clearances, HBOS expects the transaction to complete in January 2009.

(183) The full text of the Interim Management Statement can be found at http://www.lloydsbankinggroup.com/globalassets/documents/investors/2008/2008nov3_hbos_ims.pdf.

2

Divisional Review

…

Corporate

While Corporate performance has been impacted by higher impairments and lower non interest income, we have seen a modest increase in net interest income, notwithstanding higher funding costs. Costs remain firmly under control.

Since the half year, the Corporate credit environment has deteriorated, with an increasing number of customers operating under stressed conditions. The construction and real estate sectors have been impacted more severely than other sectors where current performance indicates lower levels of stress. We have been actively managing the increasing proportion of credits moving into the high risk category and will continue to do so.

The total impairment charge for the nine month period to 30 September 2008 has increased to £1,721m (£469m 30 June 2008). The third quarter charge reflects a significant increase in the collective provision in view of the worsening economic outlook. Corporate's exposure to property-related sectors accounts for around 60% of the individual provision charge. The third quarter charge also reflects certain risk concentrations and the impact of falling asset values on likely recoveries, both on existing and newly impaired assets.

The Corporate investment portfolio for the period to 30 September 2008 showed a loss of £93m (£134m profit 30 June 2008), taking into account profits on the sale of investment securities, other operating income, and share of profits/losses of associates and jointly controlled entities, less impairment on investment securities. Losses from associates and jointly controlled entities were £105m in the period to 30 September (£34m loss 30 June 2008) and impairment of investment securities increased to £284m (£145m 30 June 2008). As at 30 September 2008, the book value of the investment portfolio was £4.8bn (£4.9bn 30 June 2008).

…

Outlook

While the credit environment will remain challenging, HBOS's robust capital position, to be further enhanced by the injection of capital and liquidity facilitated by the UK Government, reinforces the Group to meet such challenges. HBOS's strong brands and leadership positions in UK Retail banking, its multi-brand approach and distribution strength in the insurance and investment markets and more selective approach to corporate and international markets, offer good growth opportunities when the current cycle turns. These opportunities will be further advanced as HBOS joins the enlarged Lloyds TSB Group in January 2009, subject to shareholder and regulatory approvals'.

773. In mid-November, and based on provisional 'flash' results for the month of October, HBOS confirmed that there was '*no material change*' since the 3 November Interim Management Statement. These confirmations of 'no material change' were necessary to enable the public documents to be issued in support of the 'Placing and Open Offer' for the proposed merger/takeover of HBOS by LTSB. These documents were issued on 18 November 2008.

774. It was around this time, in November 2008, that KPMG began to undertake the deeper, audit work for the end of year financial statements. This work led them to realise that the HBOS processes for assessing impairments and provisions could no longer be relied on. In interview, KPMG's audit partner explained: *'what transpired in relation to the backend of 2008 is that the sheer volume of cases and problems they had, essentially meant that the -- effectively, the grading of credit as we went into the true audit work in Corporate in around about November 2008, that had*

broken down. So we ended up doing significantly more work in relation to both the good book and the bad book to establish the appropriateness of provisioning'.

775. In early December 2008, based on the acceleration of the deterioration of conditions impacting the Corporate book, the Corporate Risk function presented senior management with a revised forecast for year-end provisions, showing a 'base-case' of £4.5 billion and 'downside-case' or 'worst-case' of £6.4 billion. A meeting was held, attended by the Corporate CRO, Mr Hornby (Group CEO) and Mr Ellis (Group FD), as well as Mr Cummings (Corporate CEO) and Mr Peter Hickman (Group Risk Director).(184) Again, we have received differing accounts of this meeting. Several attendees said that the purpose of the meeting was to settle the actual impairment charge to end-November for inclusion in a planned trading statement and that Corporate Risk's recommendation for the November YTD Corporate impairment charge (£3.3 billion) was accepted in full. The Corporate CRO has described the meeting as one in which he received '*significant challenge*' over the year-end forecasts. The Corporate CRO told this Review that he advised management that he did not consider the £4.5 billion 'base case' to be appropriate: (i) because of the rapid pace of economic deterioration; (ii) because of the significant amount of stressed debt that had only recently been referred to High Risk and which had not yet been assessed; and (iii) because aggregating all the individual base-case numbers was likely to be too optimistic (even if any individual outcome was possible on a stand-alone basis). We also received a number of representations disputing that two forecasts were presented. However, there is documentary evidence showing the two scenarios, and subsequent discussions between the firm and the FSA confirm that senior management chose to proceed with the lower, base-case, projections. [See **paragraph 778** below]

776. The HBOS Board met on 11 December 2008. The Board was not informed about the £4.5 billion to £6.4 billion year-end forecast range presented by Corporate Risk a few days earlier. The Board was given a narrative description of the continued deterioration of the performance of Corporate Division. The Board was asked to approve a draft trading statement. The draft gave updated figures for November impairments; it did not include a figure for year-end forecast impairments.

777. HBOS published a trading update on 12 December 2008 which stated that the estimated end-November YTD charge for impairment losses in Corporate was £3.3 billion (almost double the £1.7 billion for end-September published in the 3rd of November Interim Management Statement) and £2.2 billion for Treasury (£1.8 billion in September). The statement did not give, and was not required to give, a forecast figure for year end. The full statement read as follows:

> *'TRADING UPDATE – 12 DECEMBER 2008*
> *The following Trading Update is being provided in anticipation of the launch of the proposed placing and open offer and in advance of the meetings to be held today at the NEC Birmingham, to approve that placing and open offer and acquisition of HBOS plc by Lloyds TSB Group plc.*
>
> ***Group Overview***
> *Since the Interim Management Statement published on 3 November 2008, (the November IMS) the Group has been operating in increasingly difficult market conditions. There has recently been an acceleration in the deterioration in credit quality, and further sharp falls in estimated asset values. In addition, pressure is building on net interest margins due to the significant reductions in UK base rates. Wholesale funding costs, including funds obtained under UK Government guarantee, remain high relative to base rate and by historical standards. Deposit flows have improved with Retail inflow in November.*

(184) Mr Hickman attended for part of the meeting only.

2

Divisional Review
Retail
As stated in the November IMS, the Retail net interest margin remains stable relative to that reported for the first half of 2008, but will come under additional pressure due to the impact of recent base rate cuts. There has been a deterioration in the trend in secured lending arrears which, taken together with continued sharp declines in house prices, has resulted in an estimated secured lending impairment charge of £0.7bn for the 11 months to 30 November 2008 (£0.4bn 30 September; £0.2bn 30 June 2008). The estimated impairment charge for unsecured lending arrears is £1.0bn for the 11 months to 30 November 2008 (£0.8bn 30 September 2008; £0.5bn 30 June 2008). In light of the worsening economic climate, trends in Retail impairment charges are likely to come under further pressure.

Corporate
Corporate credit conditions have continued to deteriorate significantly since the November IMS. This has resulted in an estimated impairment charge of £3.3bn *for the 11 months to 30 November 2008 (£1.7bn 30 September 2008; £0.5bn 30 June 2008). This charge reflects an increase in the migration of exposures into the higher risk and impaired categories and sharp declines in asset values with a consequent impact on estimated recoveries. These factors are expected to continue to impact results in the short to medium term.*

Recent pronounced falls in the estimated valuations of property and other investments have impacted significantly on the value of the HBOS investment portfolio with an estimated loss of £0.8bn for the 11 months to 30 November 2008 (£0.1bn loss 30 September 2008; £0.1bn profit 30 June 2008).

Investment valuations are expected to remain under significant pressure in our private equity and joint venture businesses.

Insurance & Investment
Consistent with the November IMS, our Insurance & Investment Division continues to make a good contribution to Group results. From January 2009, we will move to offering our personal loan customers a more flexible regular premium payment protection product to protect against accident, sickness and unemployment; this will defer the timing of Group profit recognition in 2009 and later years.

International
The sale of BankWest and St Andrew's Insurance in Australia received approval from the Australian Competition and Consumer Commission (ACCC) on 10 December 2008 and is expected to complete by the end of December 2008. Credit conditions continue to deteriorate in Australia, Ireland and North America and this has resulted in some increase in impairment charges.

Treasury Portfolio
As at 30 November the estimated losses due to market dislocation totalled £2.2bn (£1.8bn 30 September 2008; £1.1bn 30 June 2008), including impairment losses in the Banking Book of £0.6bn (£0.5bn 30 September 2008; nil 30 June 2008).

In light of increasing illiquidity in the markets for asset backed securities (ABS), HBOS has changed the classification of ABS in the Banking Book from Available for Sale (AFS), where they were carried at fair value of £35.4bn as at 31 October 2008, to Loans and Receivables at the same carrying value. Following this change in classification these securities are no longer subject to measurement at fair value, although they will continue to be subject to regular impairment testing.

For the period to 30 November 2008, estimated negative Fair Value Adjustments (FVAs) in respect of the Banking Book totalled on a post tax basis £4.5bn after the reclassification to Loans and Receivables.

Market dislocation losses reflect deteriorating market conditions and credit downgrades, including downgrades to monoline insurers in November 2008. Exposure to monolines calculated on our own internal methodology totalled £1.2bn at 30 November 2008 (£1.1bn 30 September 2008; £0.7bn 30 June 2008).

At 30 November 2008, 84.4% of our ABS portfolio by nominal value was rated AAA, 5.3% AA and 3.1% A, compared to 88.3%, 6.4% and 2.0% as at 30 September 2008.

Financial Services Compensation Scheme (FSCS)
The Financial Services Authority (FSA) has issued draft guidance regarding the levies to be made by the FSCS to enable it to fulfil its obligations and compensate deposit customers of failing banks. Based on the information currently available, HBOS is likely to accrue a charge of around £200m in 2008 in respect of the FSCS levy.

Outlook
Global market and economic conditions, UK recession and increasing unemployment will continue to present a particularly challenging operating and credit environment. Lower interest rates should ease the debt burden but exert further pressure on net interest income. These factors will impact on HBOS capital ratios. However, through the injection of capital and liquidity facilitated by the UK Government, both currently and going forward, HBOS remains confident in its ability to navigate through this difficult period, as it becomes part of the enlarged Lloyds Banking Group'.

778. Shortly after the trading update, the Corporate CRO was asked about impairments by the FSA supervision team. He informed them of Corporate Risk's forecast range for year-end. The FSA followed up on this meeting with a telephone conversation with Mr Ellis the Group FD. The FSA's note of this conversation stated: '*I have discussed the corporate impairments with the FD but have not received an entirely satisfactory answer:*

- *The £6.5bn is a worst case number provided by Risk but he* [the FD] *<u>has little confidence in the underlying methodology used (more akin to guess work in his view)</u>, thinks Risk are overwhelmed and unable to make a proper assessment of the losses and put in place appropriate recovery plans. FD still sees £4.5bn as the realistic estimate of the year end position although when pushed he admits then numbers could come in higher.*

- *Key difference between the base and worst case estimates are the levels of losses against a fairly static list of borrowers. He has asked the 3 MDs who will be transferring over to Lloyds to help Risk get on top of the issues and engage in more debate as to what the likely level of losses might be.*

- *Finance (Corporate) will now report directly to Group Finance (rather than through the CEO or COO of Corporate Division).*

- *KPMG are taking a 'hard' line which the FD sees as <u>adding to the impetus to talk the numbers up.</u>* [emphasis added]

- *None of this gives us much comfort that they are on top of these numbers and is further confirmation of the systems and control weaknesses we raised with them over the summer'.*

779. The events described throughout this section in relation to the second half of 2008 illustrate the nature of interaction between HBOS senior management, the Risk functions and the external

auditors in relation to the level of Corporate impairments. While the final impairment figures at Group level were never outside the ranges deemed acceptable by the Risk functions or KPMG, it appears that:

- the degree of challenge that took place between senior management and some senior members of the Risk functions reflected a tendency within senior management to look towards the lower end of any range presented by those functions; and
- the firm kept its auditors under pressure in an attempt to keep the figures low and proposed and tried to defend impairment figures which, following intense discussion, were increased to levels that the auditors viewed as just within the acceptable range.

Subsequently, as set out in paragraph 783, KPMG was explicit in its view that the Corporate impairment figures originally proposed for the 2008 year-end were outside the acceptable range, and the further £1.9 billion which was added following KPMG's discussions brought HBOS to a balanced position overall.

780. The examples of the Risk function's interactions with senior management, in 2008 Q3 and Q4, also support the evidence seen elsewhere in this Report that the Risk functions were not accorded sufficient authority and credibility within the business so their concerns were not being listened to by senior management. This is considered further in Part 3, *'Management, governance and culture'*.

The 2008 Annual Report and Accounts

781. The scrutiny of the HBOS book further intensified in 2009 Q1 as the 2008 accounts were prepared. The merger of Lloyds TSB and HBOS completed on 16 January 2009. The membership of the HBOS Group Audit Committee was changed. For the purpose of the 2008 audit, the audit approach was extended and the basis of the audit was changed. Amongst other things, KPMG performed additional substantive testing on the good book by conducting its own assessment of the largest 30 'good book' exposures and all exposures over £100 million in category seven – 'close monitoring'. After extensive testing by both KPMG and LBG's control functions, provisions for year-end 2008 were significantly higher than the figures which had been proposed or supported by senior management in December 2008 (figures which were significantly lower that the figures being proposed by Corporate Risk).

782. KPMG's 2008 year-end report to the Group Audit Committee included a view on why the reporting of losses was concentrated in the second half of the year:

> *'Corporate and Ireland corporate books are particularly exposed to the real estate market and have suffered significant losses on house builder and property development exposures during the year. Corporate had a risk appetite for single exposure concentration well in excess of the other UK clearers. With this portfolio profile in the current market, the speed of deterioration has been overwhelming, particularly in the second half of the year. It has outpaced the resources within the Corporate High Risk and Impaired Assets ("HRIA") team, notwithstanding considerable resources being transferred in, and there is a sense of running to stand still. This has been mitigated in the short run by the front office being slow to refer credits to the HRIA team. Much of this comes from cultural aspects within the organisation which very much favours a workout approach to distressed situations but has, historically, led to reluctance to pass bad news up the line. There has also been a reluctance to recognise provisions until full information is available and an optimistic approach when calculating the provisions'.*

783. The report stated:

'We have had a number of very difficult discussions with management over the level of provisions, both specific and collective, across the book this year in all territories. We recognise that in this climate and with this portfolio, there is enormous subjectivity involved in determining provisioning and hence a wide range of possible outcomes. The discussions have led to a more balanced approach in the main UK businesses, although other banks may take a more cautious approach. Provisions in the International business remain relatively optimistic but are acceptable'.

In relation to Corporate, the KPMG report made clear that the impairment figure originally proposed by the firm had been '*outside the acceptable range*'. It stated:

'4.2 Corporate
"This year has seen unprecedented events in the economy worldwide with the UK entering a recession. Within Corporate the speed at which assets have migrated to High Risk and Impaired has rapidly accelerated throughout the year, particularly in Q4'.

'The total individual provision charge for the year was £5.3bn with a £1.4bn increase to the collective provision. This is a huge increase from the £0.6bn total charge last year, which reflects the magnitude in shift in market conditions. …'

"Following our year end credit reviews and discussions with the business and the HRIA team, Management increased the specific provisions by £677m. Following further discussions with management, the specific provisions were increased by an additional £573m. …'

'Overall provision summary [still 4.2 Corporate]
The original provision position was in our view, outside the acceptable range. Following our discussion with the business and the HRIA team, and subsequent management discussion, management has increased the individual provisions by £1.25bn and the collective provision by £0.7bn. Whilst other banks may adopt a more cautious approach, we consider that the increases have brought HBOS to a balanced position overall'.

784. A trading update was issued the following day (13 February 2009):

- *'Since its 12 December 2008 trading update, HBOS's 2008 trading has been further impacted by increasingly difficult market conditions, an acceleration in the deterioration of credit quality and falls in estimated asset values. The Group expects HBOS to report an underlying loss before tax of some £8.5 billion for the year ended 31 December 2008. On a statutory basis, adjusting for the impact of short term fluctuations (c.£0.25 billion), loss on sale of businesses (c.£0.85 billion), FSCS levy (c.£0.2 billion) and goodwill impairment (c.£0.15 billion), the loss before tax is expected to be approximately £10 billion, before the policyholder tax charge which is currently expected to be approximately £0.9 billion. The key elements of the loss are the £4 billion impact of market dislocation and approximately £7 billion of impairments in the HBOS corporate division. The market dislocation has been driven by deterioration in asset quality and falling market valuations.*

- *The impairments are, principally as a result of applying a more conservative provisioning methodology consistent with that used by Lloyds TSB, and reflecting the acceleration in the deterioration in the economy, some £1.6 billion higher than our expectations when we issued our shareholder circular at the beginning of November last year'.*

785. KPMG's controls report for year-end 2008 issued on 17 February 2009 included the following statement:

'we have summarised below the 85 control deficiencies identified during our 2008 Audit. … we have noted certain items as potential material weaknesses. This is because we are satisfied that the draft financial statements now reflect provisions that are reasonable <u>but only after significant</u>

audit challenge. It is not clear whether management's own processes would have adequately identified the additional amounts required. …' [emphasis added]

786. KPMG's overall assessment of the controls in Corporate was rated as red and KPMG warned the Group Audit Committee that: *'As a matter of priority LBG management need to address the potential material weaknesses in ICoFR* [Internal Controls on Financial Reporting] *in Corporate and Treasury and apply similar focus to the loan loss provisioning deficiencies in BOSI* [Ireland]*'.*(185)

787. HBOS's 2008 *Annual Report and Accounts* were signed off on 26 February 2009 and published shortly afterwards. They disclosed total impairment losses of £12 billion(186), and included the following statements:

'While increases were seen in all three banking divisions, the most significant increase was in Corporate. This increase reflects the worsening economic conditions, which specifically deteriorated in the last quarter of 2008. The higher impairment losses in Corporate were also the result of applying a provisioning methodology more consistent with that used by Lloyds TSB. In Retail, the increase in impairment losses mainly related to secured lending as the difficult economic conditions resulted in higher mortgage arrears, particularly in the specialist book. This, together with a material decline in house prices, resulted in increased provisioning requirements. Similar trends to the UK were evident in our International division, reflecting the deteriorating economies'.

'Page 8 ***Corporate: Financial Performance***
Underlying loss before tax was £6,793m (2007 £2,359m profit) due primarily to a significant deterioration in corporate credit conditions, particularly in the second half of 2008. Underlying net interest income increased to £2,280m (2007 £2,172m) due to the growth in the loan book arising in the first half of the year. This was partially offset by lower margins reflecting slowing of back book churn which has impacted the timing of fee recognition and the increased cost of deposits and higher wholesale funding costs'.

2.11.5 HBOS Treasury Division

788. This section of the Report into the failure of HBOS has largely used the detail from HBOS's Corporate Division to illustrate the decisions that were taken in relation to impairments and provisions as the market deteriorated from 2007 to 2008. HBOS's Treasury Division also suffered substantial losses, as set out below.

789. In February 2008, KPMG presented its report for the year-ending December 2007 to the HBOS Group Audit Committee. Prior to September 2007, no significant audit issues or control failings were identified in relation to the Treasury Division.(187) The market turbulence that followed the failure of Northern Rock in September 2007 *'resulted in additional audit focus in a number of areas across the divisions'* and, in particular, Treasury. KPMG noted that no impairments or obvious credit losses had been recorded in Treasury as a result of the changed market circumstances. KPMG's report noted that Treasury had experienced significant valuation issues, in particular with its ABS and FRN portfolios, due to a reduction of liquidity in these markets. This resulted in a *'general widening of the gap'* between fair valuations based on broker quotes and model valuation techniques. KPMG advised the Group Audit Committee that: *'Whilst we are*

(185) A red rating meant that one or more potential material weaknesses had been identified. KPMG noted certain items as 'potential material weaknesses' because it was 'satisfied that the draft financial statements now reflect provisions that are reasonable but only after significant audit challenge'.
(186) The impairment losses were initially published as £12.1 billion. These were subsequently restated following a market-wide clarification of accounting treatment by IFRIC, the interpretive body of the IASB, resulting in Group impairments for 2008 of £13.5 billion.
(187) Both the 2005 H1 interim review and the year-end 2006 review recorded that: *'No specific credit issues have arisen'* in Treasury, and KPMG agreed with management's view that 'no individual or collective provisions are required'. KPMG's Controls Report for year-end 2006 also recorded that: *'As in the prior year, we have not raised any Grade 2 points in relation to Treasury division'*.

comfortable with the valuation techniques adopted, this increases the estimation uncertainty which is present in the financial statements'. The market conditions also presented challenges for the systems and controls in Treasury. While no Grade 1 or 2 points were identified at year-end 2007, the controls report noted that Treasury had an *'ongoing programme of enhancing the quality of their underlying systems, processes and controls'*.

790. In April 2008, KPMG produced a 2008 Q1 review. While the purpose of KPMG's 2008 Q1 review was principally to report on the interim profits, KPMG was also *'requested to perform certain additional procedures in Treasury'*. These procedures involved testing the trading book over and above the auditing requirements that were in place at that time and extending trading book procedures to the banking book. The Q1 review found that *'the gap between the model-driven and broker quote values of most portfolios has narrowed'*. However, for the US RMBS part of the ABS trading book the gap had widened from £139 million at year end to £394 million at 31 March 2008. Treasury had recognised that there was uncertainty by booking liquidity provisions of £362 million during 2008 Q1 against the Alt-A RMBS trading portfolio.

791. KPMG also observed in the 2008 Q1 review that: *'Management has concluded that at present there are no specific or collective impairments required. Whilst these conditions are at present not unreasonable, we have noted in our discussions with management that … there is a need in Q2 to re-evaluate the approach, in particular to collective assessments, particularly if conditions continue to deteriorate. In addition we noted that should losses be incurred later in the year, the question of timeliness of provisions may arise and represent a challenge in demonstrating that HBOS has not been 'behind the curve' in providing for losses that were effectively already present in the portfolio'*.

792. KPMG's 2008 H1 review observed that the effects of the market conditions had been felt *most prominently in Treasury'*. KPMG still considered that HBOS valuations in respect of Treasury credit exposures were reasonable at this point. However, it noted that: *'A more cautious view could always be taken by valuing the assets closer to the broker quotes and taking a more pessimistic view on exposures to monolines where the underlying credit is impaired'*. As a result, KPMG considered that *'a further negative fair value adjustment of £300m could be made'.*

793. KPMG presented the findings of its Q3 review, which underpinned its 'no significant change work' in respect of the planned acquisition by Lloyds TSB, to the Group Audit Committee on 27 October 2008. The minutes of this meeting recorded that KPMG remained satisfied that the valuations used on Treasury assets remaining in the trading book reflected market practice. While Treasury continued to be impacted by security valuation issues due to the market turbulence, KPMG's report noted that some relief had been seen as a result of amendments to IFRS (IAS 39)(188), which enabled certain securities to be reclassified from the trading book to the AFS book. This resulted in approximately £800 million of negative fair value adjustments that would have been recognised in the P&L during Q3 to be recognised in equity. KPMG also reported to the Group Audit Committee that it had discussed with Treasury management whether a provision should be made in Q3 for either the Icelandic exposures (£0.2 billion) or a collective. It had been agreed that: *'Management will take provisions for Iceland in Q4; we have seen some take provisions in Q3 and some in Q4 and therefore this is acceptable. In relation to a collective provision we accept that a detailed exercise for impairments has been performed and any such provision would be highly judgmental'*.

794. The 2008 year-end audit opinion reflected the significant ongoing issues faced by Treasury as a result of the market turbulence. While no audit exceptions were raised against the valuation of investment securities and derivatives, KPMG reported the following results in relation to Treasury:

(188) International Accounting Standard 39 (IAS 39) is one of the standards that make up IFRS. IFRS is part of the financial reporting framework which applied to HBOS.

- *'negative fair value adjustments of £2.5bn in the FRN and ABS trading books'*;
- *'£1.4bn of impairment losses (including a £0.6bn collective provision against the Alt A ABS book)'*;
- overall, KPMG considered *'the final position on provisioning in Treasury to be within an acceptable range, although other banks may take slightly more cautious view'*; and
- in line with other financial institutions, management had taken advantage of the IAS39 amendment, which meant that *'the profit is no longer exposed to large fair value fluctuations… Without the IAS 39 amendment, a currently estimated further loss of £0.8bn would have been recorded, together with a currently estimated further write-down of reserves on the AFS book of £0.3bn'*.

795. Although the Treasury provisioning story is less material than Corporate, in part because of the change to IAS in summer 2008, it does provide an example of the step-up in challenge by KPMG from September 2007 in response to the deteriorating market conditions.

796. In its *Annual Report and Accounts* for 2008, HBOS assessed the total impact of the 'market dislocation' at £4 billion, including £1.4 billion of impairment losses. These Treasury impairment losses for 2008 were subsequently restated following a market-wide change in accounting treatment(189), to £2.9 billion bringing the total HBOS Group impairment losses for 2008 to £13.5 billion.

(189) As explained in note 1 of HBOS's 2010 *Annual Report and Accounts*, the 2008 impairment loss was restated following a clarification of accounting treatment by IFRIC, the interpretive body of the IASB.

Part 3
Management, governance and culture

3.1 Introduction

797. This part looks in detail at the management, governance and culture of HBOS and why it proved inadequate in preventing the failure of the firm. The structure is as follows:

- the design of HBOS's management and governance arrangements (Section 3.2);
- management and governance failings in practice (Section 3.3);
- failings in the implementation of the risk management framework (Section 3.4); and
- three examples that illustrate the failings of HBOS's management and governance in more detail. These cover: balance sheet management, Corporate Division, and International Division (Section 3.5).

798. We have inevitably applied hindsight in forming some of our views. In doing so we do not imply any wrongdoing on the part of HBOS or those involved by reference to the standards of the time and we are not suggesting that what is clear in hindsight was clear to those involved at the time. We have made it clear where we have concluded that HBOS was an outlier or we judge that decisions made were poor by the standards of the time.

3.2 Design of the management and governance arrangements

3.2.1 Introduction

799. This section outlines the design of the management and governance arrangements of HBOS during the Review Period. It provides context to the following sections, which explain and provide evidence of the effectiveness of these arrangements in practice.

800. The structure of this section is as follows:

- the composition and responsibilities of the Board, including the role of the Chairman and the Group Chief Executive Officer (Group CEO) (Section 3.2.2);
- the structure of the risk management framework (Section 3.2.3); and
- Board meetings and management information (Section 3.2.4).

3.2.2 Composition and responsibilities of the Board

Board

801. Broadly speaking, the composition and responsibilities of the HBOS Board during the Review Period were typical for a large UK bank. The terms of reference for the Board and those of the directors and Board committees were set out in the *Board Control Manual*(190) and reviewed at least annually.

802. The manual stated that the Board's role was '*to provide entrepreneurial leadership within a framework of prudent and effective controls that enable risk to be assessed and managed. Through its approval of, and subsequent monitoring of progress against, the Group Business Plan, and an ongoing programme of strategic reviews of individual business and functional areas, the Board sets the Company's strategic aims and seeks to ensure that the necessary financial and human resources are in place for the Company to meet its objectives and review management performance*'.

803. In terms of size and structure, the HBOS Board was similar to other large banks at the time. The number of directors on the Board varied between fourteen and seventeen, with an average of fifteen members.(191) The Board included a mixture of executive directors and Non-Executive Directors (NEDs). Broadly over the Review Period, the executive directors comprised the heads of each division together with the Group CEO and Group Finance Director (Group FD). In addition, there was an average of nine NEDs, including the Chairman.

804. As is still common for banks, certain key group functions were not represented on the Board by a dedicated director. In particular, Risk was represented by the Group CEO and Treasury was represented initially by the Group FD and, from mid-2007, by the CEO of International. This

(190) The term '*Board*' in the Board Control Manuals refers collectively to the boards of HBOS, Bank of Scotland and Halifax.
(191) Outline profiles of the experience of each of the directors are included in Appendix C and a timeline of the duration of their appointments at Appendix D.

later arrangement was particularly unusual even by the standards of the time, and sub-optimal given that Treasury was a function covering the group and it would have been more appropriate to have reported into either the Group CEO or Group FD as the two group executive directors with group wide responsibilities.

805. In 2006, the ratio of executive directors to NEDs on the Board (including the Chairman) was around 2:1 which was similar to that at the other major UK clearing banks. From September 2007, the ratio on the HBOS Board was almost 1:1, which was not in line with the guidance in the UK Corporate Governance Code(192) (formerly the Combined Code); at the other banks the ratio was around 4:6 on average at the end of 2007. The overall size of the Board at this time was not atypical for a bank.

806. Several of the directors explained in interview that, while a smaller board might have been desirable, its size was dictated by the federal structure of the Group because it was considered necessary for the CEO of each main trading division to be a board position; and sufficient NEDs were needed to counterbalance this number of executive board directors and to chair or sit on the extensive range of governance committees. This structure meant that the only executive directors on the Board with a group-wide focus, in what was a strongly federated institution, were the Group CEO, the Group FD, and from September 2007 the Group Operations Director. All of the other executive directors came from the operating divisions, although they were subject to the principles of collective responsibility, as were all Board members. The structure of the Board committees remained largely unchanged during the Review Period and was similar to the arrangements in operation at other banks at the time with no significant gaps or omissions. The terms of reference for these committees were clear and concise, as documented in the *Board Control Manual*.

Role of the Chairman

807. Lord Dennis Stevenson of Coddenham was Chairman of HBOS throughout the Review Period. As in most listed entities, the Chairman of HBOS had overall responsibility for *'leadership of the Board, ensuring its effectiveness…and setting the agenda'*.

808. The role of Chairman had *'crucial responsibilities'* including '*joint development, with the Chief Executive, subject to Board approval, of the Group's strategy; oversight of strategy implementation and performance delivery,…; and generally remaining aware and closely in touch with the Company in relation to key strategic and performance issues, to ensure effective leadership of the Board in all aspects of its role'*.

809. Specific accountabilities for the role included:

- approving the composition and chairmanship of all Board committees;
- arranging for performance evaluation of the Board and its committees;
- ensuring new directors received comprehensive induction training and that arrangements were put in place to enable all directors to update the skills and knowledge required; and
- ensuring that there was effective dialogue between the Board and shareholders.

810. While the role of Chairman was part-time and non-executive, the Annual Reports and Accounts during the Review Period made it clear that he was *'not independent'* and *'played an active role in influencing the strategic direction of the Group and ensuring overall performance delivery'*. On this

(192) *UK Corporate Governance Code* sets out broad principles of good practice in relation to boards, board leadership and effectiveness, remuneration, accountability and relations with shareholders.

basis, the Chairman participated in the firm's long-term performance-related incentive plan as well as receiving a base fee. This was different to chairmen at most other UK banks and may have contributed to the Chairman becoming too closely aligned to the Executive (see Section 3.3.3).

Role of the CEO

811. HBOS had two Group CEOs during the Review Period. Mr James Crosby[(193)] was Group CEO from when the Group was formed in 2001 to July 2006, when Mr Andy Hornby replaced him. The Group CEO's role and responsibilities were set out in the various versions of the *Board Control Manual* and were typical for a CEO of the time:

- profitability, Group-wide overall performance and operational planning, including the creation of the Group business plan;
- leading the formulation of strategy;
- the overall system of control operated within the Group;
- taking the lead in managing the businesses of the Group in accordance with the Group business plan; and
- making decisions in all matters affecting the operations, performance and strategy.

812. From January 2005, the CEO replaced the Group FD as the executive director at Board level with oversight of Risk. At that time, day-to-day management of the risk function became the responsibility of a newly created role, the Group Risk Director (GRD), which was not a Board position.

813. The Group CEO was chair of the Executive Committee (ExCo), the principal executive committee, which was in place to assist the Group CEO to develop strategy and challenge and review business plans and performance. ExCo had no authority delegated to it by the Board and so was, in theory, an advisory committee, but in practice, its role was very wide. In interview, Mr Hornby agreed that the Group was run by him and the divisional heads through ExCo.

Remuneration

814. The HBOS Board had a remuneration committee that established the remuneration policy for Board members and senior management; its role did not materially change over the Review Period. Key features of the approach included a salary policy, whereby salaries were set at the median for the banking sector, short-term incentives based on growth and performance and a long-term incentive scheme, which was available to HBOS senior management. The long-term incentive scheme was based on share options and senior management were expected to maintain meaningful HBOS shareholdings.

815. HBOS's remuneration committee and schemes were in line with practices of other major UK banks at that time.

816. Over the Review Period, HBOS's CEO received a salary that was less than the CEOs of the four largest UK banking groups but more than the CEOs of Bradford & Bingley and Northern Rock. In 2007 Mr Hornby, received total compensation of £2.3 million of which £940,000 was salary and £702,000 was an annual and biannual bonus, with the remainder comprising of an increase to

(193) James Crosby became Sir James Crosby in June 2006 but relinquished this title in June 2013.

Mr Hornby's accrued pension transfer value, and non-taxable benefits and allowances.[194] This compared to an average for bank CEO's total remuneration of £3.1 million.

817. Mr Peter Cummings, as Chief Executive, Corporate, received higher compensation than Mr Hornby in 2007, reflecting the receipt of £1.8 million in bonus payments. It is not unusual for business heads to receive higher remuneration than the CEO, as this can reflect the expected remuneration for the role.

818. In 2007 Lord Stevenson received a base fee of £708,000 and was eligible for up to 100% of this fee to be invested in a share-based, long-term, performance-related incentive plan that had the same conditions as the scheme for HBOS's senior management. As already noted, having an incentive plan as part of his remuneration was different to chairmen at most other UK banks.

819. HBOS's remuneration policy for senior management as was standard for the time focused on profitability and had no explicit requirements to consider risk. HBOS's long-term incentive scheme which deferred bonus payments through share options could be considered as innovative by the standards of the day as it effectively linked the bonus to the longer-term performance of the firm, but it did not have features of 'malus'[195] or 'claw-back'[196]. While in practice many HBOS Executives took a reasonably high level of their bonus in shares, HBOS's remuneration policies, in common with the standards at the time, did not appear to have an appropriate balance between risk and reward.

3.2.3 The risk management framework

Approach

820. Following the merger of Halifax and Bank of Scotland (BoS) in 2001, HBOS adopted a 'three lines of defence' (3LoD) approach and governance similar in many respects to Halifax's approach to risk management. The 3LoD approach worked as follows and as summarised in Diagram 1 below:

- The first line of defence consisted of the Divisional CEOs, Divisional risk specialists and the Divisional risk committees. This line of defence was responsible for 'risk management'.

- The second line of defence consisted of the Group CEO, ExCo, the Group FD (supported by the Group Capital Committee (GCC) and its sub-committees) and the Group Risk Director (GRD) (supported by various group risk committees covering different risk types). This line of defence was responsible for 'risk oversight'.

- The third line of defence consisted of the Audit Committee of the Board, the divisional Risk Control Committees (RCCs) and Group Internal Audit (GIA). This line of defence was responsible for 'assurance'.

(194) It is noted that many HBOS executives including Mr Hornby routinely took his bonus payment in HBOS shares.
(195) Malus is an arrangement that permits the institution to prevent vesting of all or part of the amount of a deferred remuneration award in relation to risk outcomes or performance.
(196) Claw-back is the repayment of remuneration or bonus after it has been paid.

3

Diagram 1: HBOS 'three lines of defence' model

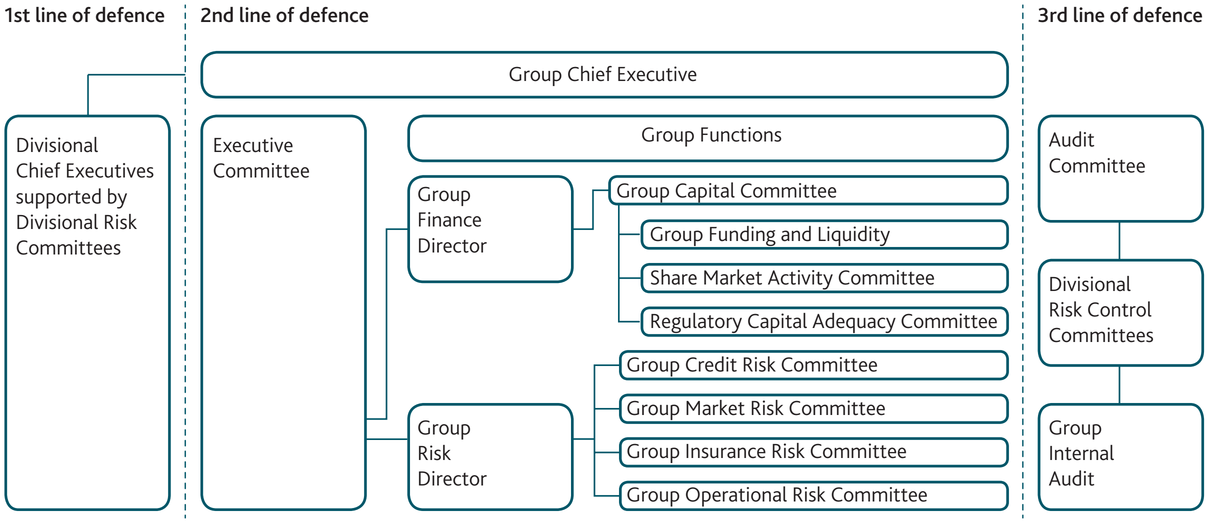


Diagram reproduced by the PRA.

821. Mr Hornby described HBOS Group as *'a devolved model where the division CEOs took responsibility for all performance aspects of their divisions – the risk parameters, the profit performance, the credit performance. But this was done within an agreed appetite….'* HBOS's risk framework (the 3LoD model) was designed around the federal structure of the Group.

822. The 3LoD approach to risk management was not uncommon among banks then or now. Its effectiveness is dependent upon a clear definition and understanding of the roles and responsibilities of each component within each line of defence. An update to the Board by Mr Mike Ellis on the Section 166 review of risk management carried out by PwC in July 2004 noted that *'PricewaterhouseCoopers (PwC) were happy to support the current HBOS* [3LoD] *structure. There was a good degree of ownership of risk within the businesses. There was clarity about roles and responsibilities. Some additional codification would strengthen the position'.*

823. However, it appears in practice that this clarity surrounding the roles and responsibilities was not evident to all, or deteriorated soon after the publication of the PwC Section 166 review of risk management.

824. An example of this was splitting of the responsibilities of the Group Asset and Liability Risk Committee (GALCO) between the Group FD and GRD, as explained in the balance sheet management illustration in Section 3.5.1.

Governance of the risk management framework

825. As noted above, both the Board and the Chairman had responsibilities related to risk management. In common with all listed companies, the Board had a specific responsibility to conduct an annual review of the effectiveness of the Group's system of internal controls and report to shareholders that this had been done. For HBOS, this review was delegated to its Audit Committee and was then reviewed and approved by the Board.

826. The GRD was not a Group Board position. It was not unusual at the time for the risk function to report to a senior board director such as the CEO or Group FD rather than be a board position in its own right (and this remains the case today, although a reporting line to the Chair of a Group Risk Committee (GRC) would now be considered normal). In addition, the GRD regularly presented to the Board and the Group CEO could bring any risk matters considered important to the Board's attention.

827. A key role of a board is to set the risk appetite for a firm. A risk appetite can be defined as the types of risk and quantification at an aggregate level a firm is willing to assume to achieve its strategic objectives and business plan within constraints, such as capital and liquidity regulatory requirements, external credit ratings and obligations to its customers.

828. Until November 2007 each HBOS division had responsibility for setting its own individual risk appetite and there was no group-wide risk appetite statement. The HBOS Board provided little or no formal guidance on the structure or format of these divisional risk appetites. This resulted in a number of differing approaches across the various divisions, emphasising the federal 'bottom-up' approach to risk and lack of a cohesive and consistent system of risk management that helped to aggregate common types of risk across divisions. The impact of not having a defined group-wide risk appetite is covered in Section 3.3.3.

829. ExCo's role in the risk framework was limited and consisted primarily of receiving and considering reports from the Executive Risk Committees. ExCo had no defined responsibility for risk despite being included in HBOS's second line of defence.

Group Risk function

830. The documented role of the Group Risk function was to:

- recommend to the Board Group policies, standards and limits;
- monitor compliance with those policies, standards and limits;
- provide leadership in the development and implementation of risk management techniques; and
- aggregate risks arising in the operating divisions and monitor the overall Group position independently from the divisions.

831. These were typical responsibilities of a function operating a second line of defence.

Group Finance Director

832. The Group FD had responsibility for the Group's Finance Division, investor relations, mergers and acquisitions, the administration of GIA and, until January 2005, Risk and Compliance. Along with the CEO, it was the only other group-wide executive director position on the Board.

833. The Group FD had oversight of the day-to-day operations and maintenance of effective systems of internal controls for these areas and was responsible for financial reporting and effective management information. This included having primary responsibility for the formation of the group provisioning policy and oversight of its implementation and reporting to the Group Audit Committee and the Board.

834. The Group FD was expected to play a key role in the development and monitoring of business plans. He was responsible for helping the CEO in the process of challenge and creation of the Group Business Plan; for testing and challenging the underlying divisional business plans; and for presenting the Group Business Plan to the Board for its approval. The role also involved leading a continuous programme of strategic reviews for presentation to ExCo and the Board.

Executive Risk Committees

835. The Executive Risk Committees were part of the second line of defence. There were a number of such committees dealing with specific risks, which after January 2006 were chaired by either the GRD (in the case of the committees covering credit risk, market risk, insurance risk, and operational risk) or the Group FD (in the case of the Group capital committee, and its sub-committees).

836. In preparation for Basel II to help HBOS demonstrate active management of the capital, liquidity and operational positions of the Group, a GRC was established in early 2005 by the Board. Its main purpose was to oversee group contagion risk and develop ways of looking at risk correlations and aggregations across the whole Group and report its findings to the ExCo. However, the GRC met only once, in January 2005[197], with separate committees covering credit risk, market risk insurance risk and operational risk continuing to monitor individual risks. In addition, a new committee was established to provide oversight of HBOS's Basel II work and waiver application.

The third line of defence

837. HBOS's third line of defence was made up of the Audit Committee, the divisional RCCs and GIA

Audit Committee

838. The Audit Committee was responsible for reviewing '*the processes and procedures for ensuring that material business risks are properly identified and managed*' and for considering '*material breaches of agreed risk limits.*' It was assisted in these responsibilities by '*the reports it receives from internal and external auditors; from the Risk Control Committees; from the Group Risk Director; and from executive management*'. It therefore had responsibilities for reviewing the effectiveness of both audit and risk management activities.

839. In essence, the role of the Audit Committee was, therefore, not to manage risk on a day-to-day basis but rather to ensure that risk was being managed. This was not out of line with the standards of the time. A typical agenda for the Audit Committee would include the following items: previous meeting minutes, including those of RCCs; regular reporting from Group Risk; and any external auditor's report. At particular points in the year the Audit Committee would also consider the annual and interim results, oversee the relationship with the external auditor and, at least annually, formally review the relationship.

840. The Audit Committee did not prepare a formal written report to the Board containing an assessment of the key risks or a commentary on materiality and priority, but provided papers to the Board on issues that it felt were important to raise.

841. The Audit Committee was also responsible for recommending to the Board the level of provisioning across the Group. KPMG reported significant judgments and findings to the Audit Committee to enable it to exercise its supervisory role, following which the Audit Committee would satisfy itself that the Group was adequately provisioned across its entire book. More detail about this is covered in Part 2; Section 2.11.

(197) The reason the GRC only met once was given in representations made by Ms Dawson. She said '*in the absence of reliable data (particularly on credit risk in the Corporate and International Divisions), it was not possible to formulate data-driven correlation and aggregation models, and the GRC could not fulfil its mandate (and I believe the minutes of this first meeting should reflect this)*'. However the meeting minutes do not reflect any such discussion and in fact noted that the GRC should meet every 2 months, with the next meeting scheduled for March 2005.

3

Risk Control Committees

842. Each of the five divisions of HBOS had a sub-committee of the Audit Committee, the RCCs, which operated under delegated authority. Each of the RCCs comprised at least two independent NEDs and could include a member of HBOS senior management and/or a specialist who was independent of the division. A number of other individuals were in attendance, such as the divisional CEO, GRD and representatives of the external auditor.

843. The RCCs met at least four times a year and their duties included review of the overall business environment, consideration of reports on process and procedure for identification, evaluation and management of risks, and review of the adequacy of the internal control systems in their respective divisions on behalf of the Audit Committee.

844. The RCCs were conceptually a good idea and had been praised by PwC in its 2004 Skilled Persons report as they allowed the NEDs to interface more closely with the frontline businesses and to exercise challenge at the divisional level.

Group Internal Audit

845. The objectives and scope of responsibilities of the GIA function were set out in the GIA Charter dated June 2006. It stated that GIA *'provides independent, objective assurance to Executive management and the Board as to the internal control environment in the Group and the operation of the risk management, control and governance processes.'* A key part of its role was to *'undertake a comprehensive programme of Internal Audit activities which supports HBOS Group in relation to good corporate governance and regulatory requirements in all jurisdictions in which the Group operates'.*

846. The Head of GIA reported to the Chairman of the Audit Committee and, administratively, to the Group FD. The Charter, an annual audit plan and the appointment of the Head of GIA were all approved by the Audit Committee. The structure of GIA mirrored that of the federal structure within HBOS. Each division effectively had a senior internal auditor assigned to it, reporting to the Head of GIA.

3.2.4 Group Board meetings and management information

847. Board meetings were held monthly and Board members were provided with a pack of monthly Group Management Information (Group MI), which included the *Blue Books*, together with a collection of minutes and other Board reports, both structured reviews and ad-hoc papers on contemporary issues.

848. The *Blue Books* consisted of approximately 100 pages of data and narrative on the performance of the Group and its divisions, together with a summary of key risks, an overview of competitor activity and a commentary on economic conditions. They were circulated monthly to around 90 people, including members of the Board, ExCo, the firm's auditor and the FSA.

849. In addition to the *Blue Books*, the Board received minutes of the previous Board meeting, minutes of Audit Committee meetings and various other ad hoc Board reports and documents concerning, for example, planning frameworks and business plans. The documentation with which they were provided could therefore be many hundreds of pages long. The Board pack was generally distributed about five days before Board meetings. Despite the volume of documents, interviewed Directors said that they felt they had sufficient time to read and digest the material before Board meetings.

850. The Board meetings included oral presentations from the Group CEO, a number of divisional heads and other senior staff on an ad hoc basis. These presentations usually highlighted

performance against plan. Each meeting also had an oral presentation from the Chairman of the Audit Committee, which was the only Board committee concerned with risk management within HBOS. 'Risk' was not a standing agenda item for the Board meetings but the GRD usually attended for at least part of each meeting.

851. Board meetings were usually scheduled to run for two to three hours and a typical agenda had between nine and sixteen separate items, which provided little time to consider each item. All directors interviewed felt that the Chairman expected everyone to have read and digested papers before the meeting so that the time allocated for discussion and debate was optimised. However, in oral and written evidence from both executive directors and NEDs, it is clear that a number of matters were discussed among the directors before Board meetings. These discussions meant that on many matters and proposals a consensus among directors was reached before formal Board meetings, and if this could not be achieved the item was removed from the agenda to be reassessed at a business level. There was a risk that this practice stifled debate as the directors were approached on a one-to-one basis and were therefore unaware of concerns raised by their colleagues.

3.3 Management and governance failings in practice

3.3.1 Introduction

852. This section explains why the management and governance arrangements of HBOS set out in Section 3.2 proved ineffective in practice during the Review Period.

853. The structure of this section is as follows:

- key failings of the Group Board, including failings by the Chairman and Group CEOs (see Section 3.3.2);
- risk management (see Section 3.3.3);
- a capable Board but lacking experience and knowledge of banking (see Section 3.3.4);
- accountability for the failings of the Board (see Section 3.3.5);and
- accountability for the failings in strategy and risk culture (see Section 3.3.6).

3.3.2 Key failings of the Group Board, Chairman and CEOs

Strategy

854. In the years following the merger and immediately prior to the Review Period, HBOS's annual business plans focused strongly on exploiting the synergies that arose from the merger. HBOS's divisions were encouraged to *'go for growth'* and the firm rapidly grew its assets, which was supported by accessing the wholesale funding. The extent of its reliance on the wholesale markets was to make it an outlier in comparison to its peers.

855. At the start of the Review Period in recognition of the late stage in the economic cycle and the fact that the integration synergies were largely exhausted, the emphasis on asset growth became more cautious, with restrained and paced growth for the UK business. The strapline for the HBOS Group Business Plan 2005 – 2009 was *'less is more'* and encouraged a focus on quality over quantity, and the Group Business Plan 2006 – 2010 was similar in tone and was focused on *'targeted growth'*. Despite the more cautious tone, HBOS still aimed to be 'top three' in all UK markets and to have a 15 – 20% market share in almost all its core markets. Although its overall growth targets were lower at 10% and 9% respectively, these remained ambitious and there was still an aim for '*continued strong asset growth in our International businesses where we are positioned as a new competitor and returns remain attractive'*.

856. The market share objective remained a target in HBOS's Group Business Plan 2007 – 2011. Mr Hornby in the August 2006 *Blue Book*, referred to strategy in the following terms: *'At the time of writing we have just finished our Investor Seminar to the City this morning! Each of our divisional chief executives had the opportunity to set out our strategies and discuss the opportunities we have for future profitable growth. In particular we laid out our determination to deliver on our twin obsessions of top line revenue growth and cost reduction'.* HBOS predicted overall asset

growth of 8% per annum (p.a.) in the UK and 10% p.a. for the wider Group. It was more bearish about the UK retail market, noting high levels of consumer indebtedness and the attendant pressure on affordability, but was more ambitious for the International Division, targeting growth of 23% p.a., while Corporate's growth rates were increased relative to the previous plan.

857. The turn of the economic cycle was explicitly acknowledged by the HBOS Group Business Plan 2008 – 2012 strapline *'when the going gets tough'*. The substance of the plan was then predicated on a *'…relatively benign outlook for the UK* [that] *could prove to be optimistic, particularly given the rising cost of funds'* and the strategic objectives continued to focus on attaining 15 – 20% market share in HBOS's core markets, while overall growth for the Group was targeted at 6% for 2008 and 9% annually thereafter.

858. From the chronology of HBOS's strategy it can been seen that it did respond to what it perceived to be the economic outlook, but its growth ambitions were always at the core of its strategy. There is some evidence that the firm did belatedly realise that its long term growth targets had been extremely ambitious. Shortly before the failure of HBOS, Mr Hornby stated as part of a strategy away day that *'we must … be hard on ourselves in admitting some of the self-inflicted actions that have made our strategic position even tougher. In particular … we did grow the business extremely strongly from 2002 through to 2007'*.

859. HBOS's strategy/business plans were prepared on a 'bottom-up' basis by individual divisions, both reflecting and reinforcing HBOS's federal structure. The Group Business Plans largely represented an aggregation of the financial plans of each division. There was a broad framework with support provided at Group level, such as the provision of macroeconomic scenarios. Approving the strategy was the responsibility of the Board. The Board, however, appears to have played a minimal role in strategic planning for the firm and, indeed, had delegated parts of its role to the Group CEO, and supported by the Group FD, in consultation with the Chairman.

860. HBOS failed to establish a Group strategy, which was set in the context of clearly identified risks and measures to quantify and control these risks. A crucial weakness of HBOS's strategic risk approach was that it was developed and pursued in the absence of a defined and binding risk appetite for the Group as a whole. This meant that, although some risks were identified during the strategic planning process, such as wholesale funding and the concentration in real estate, the significance at a Group level was not fully appreciated. Such risks were seen as constraints to the overriding pursuit of growth rather than something which needed to be addressed in its own right and integrated into the strategic planning process through, for example, the setting and monitoring of forward-looking quantitative targets covering all categories of risk. As a result, fundamental weaknesses in HBOS's strategy were never adequately identified or addressed.

861. An example of this failure to give adequate consideration to risk is illustrated by the firm's excessive reliance on wholesale funding which was frequently referred to in Board and Committee papers and minutes. Although, HBOS did extend the maturity profile and sources of its wholesale funding, its ongoing strategic priorities were focused on growth, performance and cost cutting. Risk was viewed from the perspective of constraint on growth and achievement of HBOS's strategy rather than the threat to the future stability of the firm. The vulnerability of HBOS's balance sheet to disruption in wholesale funding markets was not appropriately considered by the Board and HBOS's reliance on wholesale funding actually increased in absolute terms during the Review Period.

862. A second important weakness in HBOS's approach to strategic planning was that it used the annual divisional business planning process as the main mechanism for reviewing the Group's strategy. This meant that strategy became mixed with performance targets. Furthermore, by being a 'bottom-up' process, it failed to set a strategic direction appropriate for the Group as a whole.

3

863. The 'bottom-up' approach of HBOS's business planning process began with the production of economic scenarios and planning instructions by the Group. These were distributed to HBOS's Divisions, which produced their financial plans. These were then aggregated to form the Group Business Plan. This was explicitly highlighted in the Group CEO section of the *Board Control Manual*: '[The Group CEO, in conjunction with the Group FD, is] *to lead the process of challenge and creation of the Group Business Plan (being essentially a distillation/aggregation of Divisional Business Plans)'*. In interview, Mr Benny Higgins agreed that this was the approach taken in setting Group strategy: *'Yes, it was an exercise in arithmetic, I would say, more than anything else.'* The Divisions also presented strategy papers outlining their approach to specific topics, i.e. Retail took papers on its mortgage strategy in January, outside of the May to October planning cycle. While there were opportunities for the Board to challenge these plans, and ultimate approval of the plans rested with the Board, it acted more as an adviser to the Divisions rather than leading in setting the strategy for the Group.

864. This approach appears to have been reinforced by the federal structure of HBOS. While there was 'top-down' pressure for divisions to grow, the detail was left largely to the Divisions with limited recorded challenge from the centre, either from the Group Board or ExCo, other than to seek increased growth targets when those in the aggregated business plans did not equate to the overall growth targets required for the Group. The Chief Executives of each of the divisions were thus the principal architects of their division's strategy which drove the subsequent performance of their division, including any losses. The various Divisional Chief Executives in situ during the period are listed in Appendix 5.

865. For the business planning process to have been an effective strategic review forum, the strategic objectives contained within it should have been clearly aligned to the Group's long term objectives, as set out in the financial statements and subsequently communicated to the external market. A thorough and detailed analysis of the risks inherent in pursuing such a strategy, such as the risk presented by HBOS's increasing concentration in real estate, would also have been expected. The Board should have been active in the oversight of appropriateness of HBOS's strategic aims and its strategy through its approval of and subsequent monitoring of the progress against, the Group Business Plan, and an ongoing programme of strategic reviews of individual business and functional areas. However, we saw little, if any, evidence of debate by the Board of the continued appropriateness of the Group's strategy.

3.3.3 Risk management

Risk culture

866. The importance of the organisational culture in banks has been well documented since the financial crisis, and as part of this Review we have tried to understand the culture at HBOS during the Review Period and to identify the factors that had shaped it.

867. HBOS was a relatively young organisation formed by the merger of BoS and Halifax and at the time the partners felt that the cultures of the two organisations were compatible. In announcing the merger Mr Peter Burt, BoS CEO, stated '*most important of all is that both shared a common philosophy. Each had an objective of aggressive growth by providing a first class service to our customers. Today we will enable the combined business to grow strongly and profitably'*. Mr Crosby echoed this view, claiming that '*the creation of HBOS is all about growth; delivered through a pro-competition strategy which genuinely aspires to deliver outstanding outcomes for each of our three stakeholder groups: customers, colleagues and investors'*. It is evident therefore that 'aggressive growth' was at the core of HBOS's culture from the start.

868. HBOS's *Board Control Manual* notes that *'The Board's role is to provide entrepreneurial leadership within a framework of prudent and effective controls that enable risk to be assessed and managed'*.

While the Group Board did deliver entrepreneurial leadership, the Review found little evidence that this was balanced by appropriate acknowledgement and consideration of risk within HBOS's culture.

869. HBOS Group's entrepreneurial priority fed into the list of competencies that it used to appraise its executives. The list, headed *'HBOS DNA'*, provides some indication of the traits that were important to HBOS; risk consideration is conspicuously absent:

- *'Courage – Never backs away from an opportunity to demonstrate personal courage;*
- *Optimism – Believes the unbelievable and conveys to all around a real sense of heroic optimism;*
- *Pace – Seeking to redefine what can be achieved through relentless competitive drive;*
- *Radical – Determined to explore every opportunity and frequently breaks new ground;*
- *Valuing others – Open and non-hierarchical regardless of role or level;*
- *Intellectual capability – Curious and challenging; stimulated by thorough analysis and rigorous problem solving;*
- *Ownership – Personally invested in the business;*
- *Integrity – Aligning actions and words and providing an effective role model to the rest of the organisation;*
- *Results driven – motivated by achievement, exploiting every opportunity and overcoming obstacles; and*
- *External focus – An obsession with stakeholders and the wider market place.'*

870. The early success of HBOS in the benign economic conditions prior the financial crisis led to a degree of complacency that was in evident throughout the Review Period among some members of HBOS's Board.

871. This allowed HBOS to claim that it had *'the safest balance sheet in UK banking'* while at the same time as acknowledging that it had a '*lack of sufficient credit risk capabilities'* and an *'over-reliance on wholesale funding'*; that it viewed economic downturns as further opportunities for growth; and that HBOS had '*made the big credit cycle judgements arguably better than any large bank in the world*' just six months before it failed.

Risk management in a cultural context

872. Although the HBOS's risk management framework (the 3LoD model) looked broadly appropriate for its devolved business model it was poorly implemented. Risk was given insufficient time, attention, focus and priority by the Board. It is crucial in a bank that pursuit of growth and performance are tempered by and integrated with consideration of appropriate levels of risk management and control. In HBOS this was not the case. HBOS's growth had out-paced its risk management framework which led to stretch in its risk and control functions.

873. HBOS's weak risk culture also meant that controls could be overridden when convenient. The June 2007 *Blue Book* provided an example of where performance (in the form of fee income) took precedence over risk consideration (in the form of 'internal hurdles'): *'Deals are agreed by Corporate Banking with pricing input from Treasury which do not meet our internal hurdles but which we expect to sell on to the market via a securitisation. This allows us to make fee income from*

deals we would have otherwise rejected'. The securitisation was not in place when deals were finalised and it proved to be difficult and often impossible to sell the risk assets on to the market.

874. Weaknesses in the implementation of HBOS's risk management framework, including deficiencies in risk information were never adequately addressed throughout the Review Period. From 2005 onwards, the GRD reporting to the Group CEO had delegated responsibility for Group-wide risk management and oversight within the context of the overall system of control for which the Group CEO remained accountable.

875. A key failing of the Board was to give insufficient priority to risk management. This is not to say that the Board did not spend time on risk issues. For example, although risk was not a standing agenda item for Board meetings and there was no Board Risk Committee, the Audit Committee Chairman gave an oral presentation at each Board meeting, and the Board received the minutes of Audit Committee and RCC meetings as well as packs of management information. In addition, the GRD regularly presented to the Board and reported to the Group CEO, who could bring any matters considered urgent to the Board's attention. The Board also held regular away days during which there was some discussion of environmental and structural risks to the firm.

876. Nevertheless, it is clear that the Board did not give sufficient priority to risk relative to its focus on growth and performance, and failed to instil an appropriate culture of risk within the organisation. Examples include:

- failure to question whether high growth, high market share and unique market propositions carried excessive risk;
- not having a defined appetite for risk, including quantitative risk targets covering all risk types against which actual risk outcomes could be measured and reported;
- failing to embed risk as part of a robust strategic planning process;
- not following up on the risk information presented to the Board and challenging the business on the vulnerabilities that had been previously highlighted by the FSA and Group Risk;
- resisting regulatory attempts to strengthen risk management, such as opposing the introduction of stress testing and attempting to remove alleged *'regulatory conservatism'* from its Pillar 1 capital requirement (see Section 4.6.3) and although these requirements were eventually complied with, the initial challenge indicates that the Board did not share the FSA's views and without the FSA's intervention would not have taken the actions of its own accord;
- allowing weaknesses to persist in management information on which the Board's assessment of risk rested;
- failing to oversee properly the second line of defence (for example, through a Board risk committee);
- allowing weaknesses to persist in the operation of the risk management framework, such as the failure to aggregate risks across the Group; and
- overseeing a steady decline of the effectiveness of the control environment.

Risk appetite

877. Although it was not a common practice among UK banks during the 2000s, a key role of a board is to set a clear risk appetite for the group, in other words to set out quantifiable risk limits and parameters, along with qualitative statements, which communicate the amount and type of risk

that the group is willing to take in order to meet its strategic objectives. Recent global standards also require risk appetites to address more difficult to quantify risks such as reputational and conduct risks as well as money laundering and unethical practices.

878. From the start of the Review Period until November 2007, each HBOS division, and its associated divisional risk committee, had responsibility for setting its own individual risk appetite but no such process was undertaken for the Group as a whole. Further, divisional risk appetites tended to be set out in broad aspirational language rather than with explicit measurable risk targets.

879. While it is understood that risks were aggregated on a divisional basis, and divisions could aggregate exposures across their units, there is no evidence of a mechanism at HBOS to consider how the divisions might give rise to correlated risks and very limited aggregation of exposures/risks between them. An example is the correlation between the UK commercial real estate lending undertaken in Corporate Division and the UK buy-to-let lending that was undertaken in Retail Division. This failure to aggregate and look at risk across the Group meant that the firm remained insufficiently aware of some of its key vulnerabilities and thus was a key contributor to the failure of HBOS.

880. The *Board Control Manual* did not articulate that the HBOS Board had responsibility for setting and approving divisional risk appetite statements. Furthermore, the evidence suggests that the Board provided limited guidance on the structure or format of the divisional risk appetites, or that it had much oversight of divisional risk appetites once agreed.

881. This resulted in a number of differing approaches being taken across the various divisions, emphasising the federal 'bottom-up' approach to risk within the firm and leading to a fragmented and inconsistent system of risk management. In interview, Mr. Hornby stated that the Divisional CEOs took responsibility for all areas of performance of their divisions including the risk parameters. This was done within an agreed risk appetite that was set each year through the annual business planning process, which he went on to state the Group FD and GRD would have the largest role in co-ordinating. The role of the GRD and Group Risk in the business planning process as described by Mr Hornby was however disputed by Ms Jo Dawson, in representations made to the Review. Ms Dawson stated *'In my experience, the GRD and Group Risk team had limited involvement in the process and were not invited to attend the "challenge meetings" which were held by the Group CEO and Group FD with each Divisional CEO following submission of their draft plans'.*

882. Weaknesses in HBOS's approach to setting risk appetite were highlighted in a January 2007 paper prepared for ExCo by Mr Dan Watkins. The paper noted that '*currently the assessment of HBOS's Risk Appetite is largely reliant upon expert judgement and the articulation of it is a by-product of the business planning process*' and that '*business and capital plans are agreed by the Board. Implicitly this defines a level of risk which the Board can tolerate within our overall strategy*' which appears to suggest that the business plans determined risk appetite, rather than the other way around. Critically, the paper set out weaknesses in the current process:

> '*The current process does not explicitly identify which sorts of risk should be sought or avoided on the basis of current economic conditions, the markets in which we operate and the probabilities of various scenarios which might affect performance or of our risk management competencies. Typically, some of these views emerge from discussions at, for example, the ExCo Away Day, but are not necessarily formalised.*'

The paper went on to set out that the Group intended to enhance its approach, with the stated intention of '*ensuring that the Group's performance is commensurate with risk being taken … informing decision-making involving trade-offs between risk and reward at the margins*'.

883. In 2007, following an industry-wide FSA recommendation, HBOS began work on its first Group-wide risk appetite statement (GRAS). The GRAS was formulated with input from senior management, various risk committees and use of peer benchmarking, and was approved by the Board in November 2007.

884. The GRAS (incorporating a new 'risk dashboard') was intended to be 'business as usual' in the first half of 2009, in time for the 2010 – 2014 business planning process. The GRAS risk dashboard was subsequently implemented and reviewed on a quarterly basis in 2008 by the Group Regulatory Capital Adequacy Committee.

885. The Divisions were not encouraged to align their own risk appetites with the overall Group appetite until at earliest November 2007 (although as stated this was not intended to be implemented as 'business and usual' until 2009). It therefore came too late in HBOS's lifespan to assess whether HBOS's approach to defining and monitoring a Group risk appetite would eventually have assisted in signposting the failings within the divisions for the Board.

Appointment of non-specialist Group Risk Directors

886. The lack of priority placed on risk by the HBOS Board was further highlighted by the appointment of non-specialists to the role of GRD and the short tenure of the appointees before they were moved on to a new role.

887. The role of GRD at HBOS was created in January 2005 to head the existing Group Risk Function. During the Review Period, there were three GRDs: Ms Dawson, Mr Watkins and Mr Peter Hickman. Neither Ms Dawson nor Mr Watkins had any prior risk experience, and Mr Hickman had little experience in the key area of credit risk. None of the three GRDs stayed in the post for more than 18 months before moving on to a new role in the organisation.

888. While it is possible for non-specialists to rely upon the skills of more technical staff in areas such as risk until they have built up the requisite knowledge, such appointments will inevitably entail a degree of disruption for the operation of the Risk Department. Moreover, non-specialists may not be able to challenge the information or explanations they are given, particularly from other senior individuals in the organisations, until they have built up sufficient knowledge to be able to assess the relevance, accuracy and robustness of the detail provided. This was almost certainly the case with the holders of the HBOS GRD role; they simply did not have sufficient time in the role or prior experience to become adequately effective. Then, by the time they had gained the experience, they were moved on.

889. It is worth noting that concerns about the appointment of a non-specialist as the first GRD in 2005 were directly brought to the attention of the Board, because of associated whistleblowing allegations and the investigation that followed (see Box 4.10 in Part 4).

Risk information

890. While the Board received information on risk via the monthly *Blue Books* there were weaknesses in the way the information was presented, as well as the quality of the underlying data.

891. Unusually, preparation of the *Blue Books* was co-ordinated by the HBOS Investor Relations team who saw this as an early opportunity to present their growth story to the market. This most likely contributed to more focus on growth and performance rather than risk in the Group MI packs; risk often got cursory coverage in the CEO Reports to the *Blue Book*.

892. Another weakness with the *Blue Books* was that, although they included summaries of risk issues, it was not always clear to the reader what the key concerns were. For example:

- variances against plan were not always explained;

- there was a lack of consistency in the way in which data were reported between divisions, making it more difficult to evaluate risks on a Group-wide basis;

- messages deemed important were highlighted in red, but often a considerable amount of the text was highlighted in red, making the reports difficult to read, and blurring which messages were truly important;

- there was an imbalance in coverage given to 'good' news relative to 'bad' news;

- there was little forward-looking risk information; and

- the sheer length of the *Blue Books* and Board packs meant that key messages could easily be missed.

893. Weaknesses in the presentation of MI in the *Blue Books* had been identified by HBOS during the Review Period. There was a planned project to implement a significant overhaul of the *Blue Books* at the end of 2007. It is not clear if this overhaul ever took place but, even if it did, there was little difference between the *Blue Books* published prior to and after this point. In mid-2008, KPMG raised concerns that the MI in the *Blue Book* had not responded to the new demands arising from the financial crisis.

894. The issues about the quality of the underlying data in the *Blue Books* also persisted throughout the Review Period, bringing into question their effectiveness as a monitoring tool. The *Blue Books* themselves contained numerous references to data issues and quality of data, including noting the inadequacy of models in Corporate needed to support the Basel II project.

895. In May 2006 the Group Credit Risk Committee (GCRC) asked Group Credit to provide an analysis of the Group's exposures to property across divisions. Several parts of the business were unable to do so, due to a mix of weak systems and the short time frame of the request. The report concluded that '*the most significant conclusions can be drawn from the difficulty in obtaining data beyond headline asset exposure at a high level from some businesses…This is more concerning in the higher risk segments. It also makes it difficult to make trade-off decisions… should we wish to limit growth*'.

896. When the paper was first presented, the GCRC, recognising the poor data-quality, noted that the divisions should try harder to provide the relevant information and that the report should be escalated to the ExCo of the Group. An updated version of the paper with some of the previous data gaps filled, but with many left empty, was presented to the GCRC again in July, when it was decided to send it to Mr Hornby and the Group FD, Mr Phil Hodkinson to feed into the Group's annual planning process, rather than present it to ExCo. The HBOS Group Business Plan 2007 – 2011 does not articulate a strategy to improve data-quality. Under the heading of Credit Risk the paper states '*Our credit systems and processes will need to be scaled up and streamlined to support the anticipated growth. In the event of an economic downturn, our operations already have suitable pricing and performance management tools in place to provide assistance to ensure the right balance of return and credit quality is achieved, and appropriate governance resources are in place. Embedding Basel II into business as usual and an increased focus on data accuracy will improve the performance of our credit models, resulting in significant business benefits'.*

897. The MI in Corporate seemed to have been of particular concern. For example, in interview, a senior individual within Corporate risk assurance, expressed surprise that key controls were only recorded on spreadsheets rather than embedded within systems. Mr Tony Hobson, NED, Chairman of the Group Audit Committee, noted in his FSA Enforcement interview that '*management information in Corporate was…lacking*'. Although HBOS took a number of steps to address Corporate's MI, this issue was identified in the Corporate Business Plan 2008-2012 which noted '*inadequate MI*' as a weakness in the Division.

898. Persistent weaknesses in the quality of Corporate MI was a key factor in the difficulties faced by HBOS in achieving Internal Rating Based (IRB) status for its Basel II credit risk models and stretched the resources of the risk department.

899. Poor Corporate MI became even more critical following the onset of the financial crisis because it disguised the extent to which lending was continuing to grow despite the decision to slow it down and provided misleading information on exposures.

900. The April 2008 *Blue Book* included the following illustrative narrative:

'Data Accuracy: Corporate data quality has been a key area of focus of the division for several years. Corporate recently reported a significant unplanned increase in Risk Weighted Assets as a result of data accuracy issues.

At the same time Corporate has:

- *22% of ratings out of date (they require to be rerated);*
- *60% of ratings requiring attention (no data available regarding materiality);*
- *concern that collateral values are not accurately recorded; and*
- *concern that restricted limits (conditional drawdowns) are not accurately recorded.'*

901. Throughout the Review Period, the International Division also had significant issues about the quality of MI, but there is little evidence of follow-up actions to improve the degree of information available.

902. For example, the International RCC received quarterly reports on the performance of each operating division within International, but these reports regularly included only narrative descriptions of financial performance against plans, without clear statistics. The financial information available was high-level before the introduction of Basel II, when there were improvements in granularity. However, continued changes in format and content meant that meaningful trend analysis would have been challenging.

903. Retail made more effective use of data with MI providing a much more detailed view of risks in the book than for Corporate and International. The large number of transactions carried out in a retail business makes it easier to apply statistical tools. Furthermore, HBOS had the benefit of a long run series of data on loan performance which enabled it to assess potential losses more effectively. Nevertheless, it does appear that HBOS failed to appreciate the impact of the rate of churn[198] on its book: over-optimistic expectations of the churn rate may have led HBOS to overstate future income streams, and led to inappropriate product pricing. This was a challenge faced by many mortgage lenders across the sector at the time.

Challenge

904. A third key weakness in the governance of HBOS was the lack of effective and informed challenge by the Board. As a consequence key risks and vulnerabilities accumulating at a Group level as a result of the strategies being pursued by the divisions, notably Corporate, International and Treasury, were not fully explored, understood or addressed by the Board.

(198) 'Churn' in the context of this report is the rate at which customers terminate their relationship with a bank over a given period of time. The rate of churn contrasts with that of growth, if a bank is to grow growth rates must exceed the rate of churn.

905. The summary style of recording Group Board meetings makes it difficult to ascertain what discussion took place at Board meetings and the level of challenge by the Board. To illustrate this, the minutes of Board meetings often summarise the papers presented, for example, extracts from a paper presented on 'risk appetite statements' are quoted verbatim without further comment in the Board minutes dated November 2007. There is no evidence of substantive discussion of this issue.

906. The view among most of the directors interviewed was that the Chairman, Lord Stevenson encouraged debate and challenge, and that dialogue between non-executive and executive directors was welcome and free flowing. Sir Brian Ivory, for example, said that '… *there was certainly a culture of challenge around the Board table*.' Mr Crosby, said that challenge from NEDs would often *'come through the Chairman'*, who could be *'very, very challenging'*. Sir Ron Garrick stated *'I have no doubt that the HBOS Board was by far and away the best board I ever sat on'*.

907. Ms Dawson, however, said that the Board would have benefited from more discussion, which would have been facilitated if Lord Stevenson had not summed up his agreement (or otherwise) to the proposal in advance of opening up the debate for questions from other NEDs. Mr Higgins said that '… *I sat through Board meetings, and I didn't witness much challenge on many aspects of the business'* and that there was '*unwillingness to create dissonance*'.

908. Similar sentiments were expressed in a 2007 NED discussion of the performance of the Chairman and '*the general operation of the Board, and the Board processes*'. This included a general desire for more debate and challenge within Board meetings and *'slight concerns in relation to the Chairman's style, particularly with Board meetings, which did not always appear to encourage debate or contributions from around the Board table*'.

909. Other comments included a general desire for more debate and challenge within Board meetings, although it was noted that '*the position was improving. But prior consideration of issues at ExCo may not help'*; and an observation that '*the breadth and complexity of the Group's businesses was a challenge, particularly for non-executives. All directors needed to be sufficiently well informed to be able to challenge and question issues and proposals brought to the Board'*. The summary of the 2008 NED discussion suggests that some of these previous concerns were *'now much more muted – reflecting improvements during the past 12 months or so'*.

910. While the direct evidence on challenge is mixed, there is substantial, albeit circumstantial evidence to suggest that effective challenge from the Board was limited, particularly around the key risks faced by the Group, even when the Board was provided with information that should have alerted members to growing problems.

911. One example of this apparent lack of effective challenge is around the weak and deteriorating quality of the Corporate book. As highlighted in Section 3.5.2 – Management and governance failings in relation to the Corporate Division, between 2006 and 2008, the Board was repeatedly told by Mr Cummings that Corporate Division was pursuing a low risk strategy and that the Corporate book was 'good quality'. However, at the same time, the Board was regularly being provided with a growing list of very large exposures to sub-investment grade corporates. Yet there is no evidence that the Board challenged Mr Cummings on the growing exposures, or the upbeat messages on the Corporate book being presented by management even though they were also being alerted to the fact that external observers, including the FSA, had concerns.

912. There is a similar lack of evidence in contemporaneous documents of challenge by the Board around:

- the failure of internal controls to keep pace with the rapid growth in the firm and the steady decline in the effectiveness of the overall control environment, which was rated green (satisfactory) by GIA at the start of the Review Period but had deteriorated to amber (adequate with reservations) by mid-2007;

- the failure to reduce the Group's funding gap and over-reliance on wholesale funding, despite its size being highlighted to the Board on numerous occasions (see Section 3.5.1);
- the fact that Corporate exceeded its lending targets in 2006 and 2007 and whether Corporate was taking excessive risks in pursuit of these results (see Section 3.5.2);
- the self-confident claims of Corporate including that it had unique expertise and significant competitive advantage over peers;
- the delays to achieving IRB status and the conditions imposed by the FSA once IRB status was approved subject to a significant number of conditions being met;
- the duplication of strategies used in the United Kingdom by International in Ireland and Australia without consideration of whether this was appropriate given structural and economic differences, and could lead to concentration risk (see Section 3.5.3);
- the regular raising of limits when they were about to be breached;
- the Treasury investment strategy (prior to the appointment of Mr John Mack as a NED);
- the failure to address problems around the quality of management information; and
- following the onset of the financial crisis, the continued lending by Corporate despite evidence that other banks were withdrawing from the market (see Section 3.5.2); the optimism in re-forecasts; and the decision not to sell the alt-A book (see glossary) as the underlying credit was good.

3.3.4 A capable Board but lacking experience and knowledge of banking

913. An important factor which adversely affected the Board's performance was its composition, which lacked NEDs with sufficient experience and knowledge of banking, particularly corporate banking. This inexperience impaired the Board's ability to provide effective challenge to the Executive and contributed to the firm's pursuit of growth strategies that took insufficient account of risk.

Executive directors

914. Neither of the two Group CEOs during HBOS's existence had significant banking experience prior to assuming the role. The first Group CEO-Mr Crosby-was an actuary by profession. He joined Halifax Life in 1994 as Managing Director, becoming CEO of Halifax plc in 1999. Subsequently, on the merger of Halifax with BoS in 2001, Mr Crosby became Group CEO of HBOS.

915. The successor to the Group CEO role was Mr Hornby. He had been CEO of Retail and then Chief Operating Officer (COO) from mid-2005 prior to becoming Group CEO from August 2006, though in practice, he was in effective control from approximately January 2006. Indeed, by being given delegated responsibility for the creation of the HBOS Group Business Plan 2006-2010 (subject to Board approval) as COO in 2005, Mr Hornby was central to establishing the strategic goals for the firm from an even earlier point.

916. Before joining the Retail Division of Halifax in 1999, Mr Hornby had held senior positions in a number of retail organisations, notably Asda, but had no previous experience of financial services.

917. There appears to have been little disquiet on the Board at the appointment of Mr Hornby as Group CEO despite his limited banking experience. The only exception to this was Mr George Mitchell (CEO of Corporate and Head of Treasury, 2001-2005). During his interview, Mr Mitchell stated that he resigned from the Board and HBOS because he *'didn't believe he* [Mr Hornby] *had the experience or the expertise to be running a major high street bank. He had plenty of intellect but experience and expertise are every bit as important'*. Although Mr Mitchell stated that he made the Chairman aware of this view at the time, the Review has not seen any contemporaneous evidence of such a conversation.

918. The Board did not perceive the CEO's limited banking experience to be a particular area of concern and therefore did not put in place measures to provide the new CEO with additional technical support or training.

919. The majority of the other executive directors on the HBOS Group Board during the Review Period had retail financial services experience and background. Of the twelve executive directors who served on the Board during the Review Period, only three had any significant corporate banking experience, and all of them were in risk taking roles with none in risk managing roles:

- Mr Mitchell (CEO of Corporate and Head of Treasury, 2001-2005);
- Mr Cummings (CEO, of Corporate, 2006-2009); and
- Mr Colin Matthew (CEO of International, 2005-2009, various director roles 2001-2005).

Each of these had spent a considerable number of years in banking, exclusively with BoS and HBOS, before their appointments as executive directors. They had no experience in other banks.

920. There was little corporate banking experience among the other executive directors on the Board. In particular, none of the three Group FDs during the Review Period had any prior experience of corporate banking (although Mr Ellis had operated in the Halifax Treasury function). This lack of experience was particularly important given that the CEO and Group FD were the only two executive directors with a group-wide perspective in a federally structured firm.

921. The role of Group FD of HBOS was held by Mr Ellis from the time of the merger until he retired in 2004 (Mr Ellis later returned as Group FD in September 2007). Mr Ellis had previously been Group Treasurer of Halifax Building Society from 1987. For a short time following Mr Ellis' retirement, the role of Group FD was held by Mr Mark Tucker, who had insurance experience but no prior banking experience. Mr Hodkinson, who succeeded Mr Tucker as Group FD between March 2005 and December 2007, similarly had no material banking experience. Mr Hodkinson was an actuary and had a background in the insurance sector, most notably at Legal & General.

922. From late 2004 to early 2008, there were many changes at senior management level at HBOS (see Appendix 5). As the great majority of these appointments were in effect internal moves and promotions, there was a cascade of other changes throughout the business. This inevitably caused short-term operational stretch and disruption within the affected divisions and functions.

923. In addition, by promoting internally (with the exception of Mr Higgins, who left the firm after less than 18 months), HBOS forewent the opportunity to bring in experienced external specialists, who could have strengthened institutional knowledge and expertise in areas such as risk.

Chairman and the NEDs

924. Among the NEDs on HBOS's Board during the Review Period there was a striking lack of operational banking experience and knowledge of banking in relation to the firm's largest business and risk areas (Retail Banking and Corporate Banking), as well as Treasury, until the arrival of Mr Mack.

925. The Chairman of HBOS throughout its lifetime was Lord Stevenson, who had held the same role with Halifax from 1999 until the merger. Having run a management consultancy, which he co-founded in the 1970s, Lord Stevenson's background was not in banking, though he had held a non-executive post at Lazard Brothers from 1997 to 2002 (along with a number of other non-executive roles mainly in media companies).

926. Of the other eleven Group NEDs who served on the Board during the Review Period, only Mr Mack (2007 to 2008) – a former treasurer at Bank of America – had any operational banking experience, but he arrived late in the Review Period. Two other NEDs came from a financial services background, namely:

- Mr Hobson (2001 to 2008), a former Chief Financial Officer (CFO) at Legal & General; and
- Ms Kate Nealon (2004 to 2008), a former Head of Legal and Compliance at Standard Chartered Bank.

927. The remainder of the NEDs were drawn from a range of non-financial industries and, in one case, an accountancy firm (see Appendix 6 for a full list of NEDs and previous experience).

928. A lack of banking experience and knowledge of banking did not necessarily make these NEDs individually ineffective. The NEDs were all people who had achieved a high degree of success in their own fields and could look at matters from a different perspective. Moreover, as the NEDs had all held senior positions, they should have been more than comfortable challenging the executive directors on their plans.

929. However, the ability of NEDs without relevant knowledge of banking to provide effective challenge across the full range of risks faced by a complex business such as a bank would inevitably have been less, particularly without adequate training. Mr Hobson described how his prior experience in insurance helped him in his roles as Chairman of the Audit Committee and the Divisional RCCs for Insurance and Investment Division (IID) '… *And I think I have a very good understanding* [of IID], *and that was driven mainly because there were a lot of similarities between Legal & General, where I'd been for 15 years, and Clerical Medical. … I also knew some of the people already who were at HBOS through my 15 years at Legal & General.*' In contrast, Sir Ron Garrick, who had been highly successful in industry and was chair of the Corporate RCC, described the extent of his prior banking knowledge as: '*only in terms of companies borrowing and arranging overdraft facilities*'.

930. A period of intensive induction into the bank's operations and the risks such operations entailed, and regular 'top-up' training could have made the NEDs that lacked prior knowledge of banking better able to provide effective challenge to the executive directors on more technical issues. Such training could have included risk and strategy. *The Higgs Report* in 2003, for example, recommended that: '*A non-executive director should insist on a comprehensive, formal and tailored induction.*' The *Combined Code* states that: '*Once in post, an effective non-executive director should seek continually to develop and refresh their knowledge and skills to ensure that their contribution to the board remains informed and relevant.*'

931. It is not clear, however, the extent to which the NEDs at HBOS received, or had access to, such training. Both Mr Hobson and Sir Brian Ivory indicated in interview that some limited training

was provided to the NEDs. Other NEDs said that there was an induction programme of meetings with relevant executives and senior managers, some ad hoc training on specific matters, and then they were free to meet with heads of business units and learn on the job but that was largely left to each individual. There did not appear to be a systematic process whereby NEDs were updated on banking, regulatory or governance matters on an ongoing basis.

932. With limited knowledge of banking and subsequent training, most of the NEDs were to a large extent, reliant on the data and explanations they received from the executive directors and senior management. In his interview with the PCBS, Sir Charles Dunstone, who was Chairman of the Retail RCC between January 2005 and April 2008, confirmed that he had only a limited ability to challenge the financial and risk controls in the Bank:

'QC: *One of the responsibilities of a non-executive director, as set out in the board manuals, was to satisfy you that financial controls and risk management systems were appropriate. Is that something you felt qualified to do?*

Sir Charles Dunstone: *I felt I could take a view of what was being presented to me, within my experience of business and common sense, and try to make a judgement, alongside all of the other expertise on the board of what felt reasonable.*

QC: *But in terms of a more informed view – for example, adequacy of risk controls – that would really be something that someone else on the Board would have to do?*

Sir Charles Dunstone: *Indeed, yes.*'

933. With Board members having to rely on others to provide appropriate challenge in key areas, the 'gaps' in Board experience would therefore significantly impair the overall effectiveness of the Board.

Appointment of Mr Mack

934. The Board appears to have appreciated that there was a lack of banking experience within its membership with the appointment of Mr Mack in May 2007. The FSA's Note for Record with Sir Ron Garrick following an ARROW visit stated: '*NOMCO* [Nomination Committee] *looks for diversity but meritocracy… Feedback from ExCo was that there had been insufficient challenge on banking issues so this was a priority leading to John Mack's appointment*'.

935. In evidence to the PCBS, Mr Hobson also highlighted the importance of additional relevant knowledge of banking. On being questioned whether there was sufficient knowledge of corporate banking on the Board, he said that '*with the benefit of hindsight, if we had had John Mack, for example, during that whole period of HBOS's existence, that would have been very helpful to us. I think he brought a different dimension and different perspective that would have been very helpful*'.

936. The different perspective is illustrated by Mr Mack's recollection of having discussed HBOS Group's liquidity with Lord Stevenson and Mr Hornby. He recalled expressing the view that notwithstanding the prevailing regulatory regime, as a business manager he was concerned about HBOS's liquidity levels.

3.3.5 Accountability for the failings of the Board

937. As Chairman of HBOS throughout its lifetime, Lord Stevenson bears responsibility, individually and collectively as a Board member, for the failings of the Board during the Review Period. As well as setting the Board agenda, the Chairman was responsible for: the composition of the

Board and its lack of operational banking experience; the manner in which Board meetings were conducted and the absence of open discussions in Boards which would have facilitated effective challenge. Further, in line with the accountabilities set out in Section 3.3.3, the Chairman also bears responsibility for any deficiencies in the induction programme and any ongoing training for the NEDs.

938. In interview, Lord Stevenson said that he had sought NEDs with appropriate knowledge of banking and towards the latter end of the Review Period he did recruit Mr Mack when the opportunity presented itself. Lord Stevenson noted that this search had been lengthy and difficult; the problem being that, due to perceived 'conflicts of interest', current or former top executives from other large banks were unwilling or unable to take up roles with current or former competitors. If HBOS had sought someone who had been more involved in the 'nuts and bolts' of banking, albeit able to perform and contribute at listed board level, rather than 'former top executives', then the search may have proved fruitful more quickly.

939. Another key responsibility of the Chairman was to undertake periodic reviews of how effectively the Board was performing. Such a process, if carried out rigorously, might have identified the weaknesses in the Board and led to them being addressed.

940. In interview, Lord Stevenson said that he met with individual directors about once every two or three years to obtain and give feedback, and then he produced a report which would be discussed as a Board. The Review was unable to form a view on this, however, as no records of any such reviews have been found.

941. The 2005, 2006 and 2007 Annual Reports and Accounts all include comment on the effectiveness of the Board within the Corporate Governance section. Each year it was stated that '*performance and effectiveness of the Board and each of its Committees is evaluated annually*', in none of these years did the evaluation identify '*material failings or weaknesses*'. However, the Review has seen no evidence to confirm that these were carried out, or what the outcomes if any, were.

942. There are, however, records of meetings held in 2007 and 2008 by the NEDs to consider the Chairman's performance and the effectiveness of the Board, which led to changes being made.

943. So, while there is evidence that an annual evaluation of the Board's performance and effectiveness was undertaken, at least in 2007 and 2008, it is not sufficient to suggest that this was in line with the guidance at the time or a formal and rigorous evaluation advocated in principle A6 of the *Combined Code*.

3.3.6 Accountability for the failings in strategy and risk culture

944. As outlined in section 3.2.2, the responsibilities of the HBOS Group CEOs included the formulation of strategy, development of Group Business Plans, the overall system of control, and acting as the executive director at Board level with oversight of risk.

945. Although there is no evidence to suggest that either of the two CEOs exerted undue dominance over ExCo or the Board during their tenure, they along with the Chairman did have strong influence over the direction of the business and the culture of the firm. At the start of the Review Period the strategy was clearly focussed on short-term performance and growth. Subsequent Group business plans sought to slow the growth of new business, but did not pay sufficient attention to the mitigation of risk that was already present in the back books. Thus this focus on short-term returns and growth remained a feature of the plans, including those at the end of the Review Period when more radical actions were required.

Tone from the CEOs

946. The role of the CEO is such that, in seeking to lead and motivate, it is necessary to emphasise optimism, confidence and growth potential. While this is not regarded as a shortcoming in itself, in the absence of sufficient balancing messages about giving due consideration to risk and controls, it can become problematic.

947. The general consensus among the other HBOS directors interviewed was that both Mr Crosby and Mr Hornby were approachable and supportive Group CEOs who were seen as leaders of the Group. None of the directors or other interviewees has suggested that either Mr Crosby or Mr Hornby was domineering as Group CEO or that they felt forced by the Group CEOs into taking actions with which they were decidedly uncomfortable.

948. Nevertheless, during their tenures as Group CEO, Mr Crosby and Mr Hornby played a fundamental role in reinforcing a culture within the firm, which leaned heavily towards growth and performance. In interview, both Mr Hornby and Mr Crosby denied that they pushed a growth culture. Nevertheless, there is plentiful evidence to suggest that they did just that.

949. Such messages were conveyed in communications such as the CEO reports to the Board and commentaries to the *Blue Book*. For example, in the June 2005 *Blue Book,* Mr Crosby commented: '*For the first time in many years (touch wood!) after six months we are well ahead of a typically ambitious HBOS plan*'. Mr Hornby's CEO Report to the February 2006 *Blue Book*, meanwhile gave this typical message '*Whilst the share price reaction to our results was perhaps inevitable given our incredibly strong run in January and February, it merely increases the necessity for us to out-perform expectations in 2006*'. However it is noted, that the Group Business Plan produced in 2004 covering the period 2005–2009 was titled *'Less is More'* and the focus was purportedly on consolidation.

950. A senior member of HBOS Finance described the situation as follows: '*…the growth factor came through loud and clear every time James* [Crosby] *spoke and Andy* [Hornby] *spoke. It was: "We are better than the competition. We can grow faster. We can do this, this, and this"*'.

951. Frequently, the Blue Books included strong messages from the CEO on his expectations for growth and market share in various divisions, with statements such as:

- *'In General Insurance the finances are good, but we need sales growth!';*
- *'…the Retail team are confident of hitting a full year* [market] *share of between 17%-18% and we briefed the market to expect this result. Under* <u>*no*</u> *circumstances can we miss this revised target';* and
- *'We cannot afford to let volumes slip in our international businesses. This will be a tough challenge as we seek to drive forward our expansion plans – but it is one we must rise to if our international aspirations are to be taken seriously by the market'.*

952. There is also some evidence that the pressure for growth was communicated directly to Divisional heads during the business planning process. When questioned by the PCBS sub-committee about increases made to Corporate's targets in early 2007 and whether this was as a result of 'pressure' from the Group CEO and Group FD rather than 'guidance', Mr Cummings stated:

'*QC: Were you in a sense being pushed to do things you really did not think were safe, sound or achievable, or was it part of the normal process of budgeting that companies go through?*

Mr Cummings: I think, to be fair, it is a bit of both.'

A member of the GIA Leadership Team echoed this remark: '...*I've had conversations with Peter Cummings where he'd come back from a Board meeting and say: Andy* [Hornby] *wants me to grow the business faster or do more – something along those lines*'.

953. Sometimes challenges to the business were presented as opportunities for further growth. Mr Crosby stated in the HBOS Group Planning Framework 2006 – 2010 '*These challenges are heightened for HBOS by the slowdown in the UK economy with smaller mortgage market and lower house prices, coupled with the prospect of being closer to the turn in the corporate cycle. However, we believe this background presents us with further opportunities for growth and importantly, more scope to differentiate our performance from others. Our business model is hard to replicate and should be even harder to beat in this environment*.'

Other challenges arose in playing down criticism from external parties, as in the following two quotes:

'*The market has consistently fretted about the likelihood that growth at HBOS will ultimately end in tears. In reality ... credit quality experience … .has been significantly better … our challenge is … to ensure … this remains the case'*.

'*The* [Corporate] *Division had demonstrated strong and sustainable growth since merger although external audiences were not yet fully convinced of the quality and sustainability of Corporate's earnings'*.

954. As would be expected, Mr Hornby also placed significant importance on market perceptions and what he believed financial analysts wanted from the Group, namely growth, and this appeared to be a driver for HBOS strategy. Mr Hornby's CEO Reports to the April 2006 and September 2006 Boards, for example, emphasised respectively that the Group needed *'to ensure that market expectations were surpassed in 2006'* and that *'delivery ahead of market expectations was still critical'*, while the CEO Report to the March 2007 *Blue Book* stated '*The Retail team is very alive to this issue* [i.e. lending growth being below plan] *but nevertheless a strong Q2 is essential to maintain credibility both with the City and our major intermediary customers*'.

955. This market-focus fed through into strategic planning. Mr Hornby, for example, identified one of the three key aims of the June 2007 ExCo Away Day as being to *'build key messages for investors'*. The Away Day minutes also record Mr Hornby as stating that *'it was critical for the Group to re-establish credibility with Investors and City audiences'*.

956. Following the failure of Northern Rock, the CEO's focus on market perceptions and expectations intensified, with numerous references in Board minutes, ExCo minutes and Group Business Plans to concerns about '*spooking the market*'.

957. In interviews market participants commented that through 2007 and 2008 it was difficult to understand the true position of the firm from management, and that its rhetoric (e.g. through analyst calls) did not always reconcile with the deteriorating fundamentals. In addition, several market participants noted that they had begun to sell their holdings in HBOS by the summer of 2007 – before the failure of Northern Rock – on account of their concerns.

The CEO's focus on risk

958. As outlined in Section 3.2.2, the Group CEO was responsible for the overall control system operated at HBOS and was the Executive Director responsible at Board level for the oversight of risk. However, neither of the two CEOs had any experience of risk in a banking context and it is questionable whether they put sufficient priority on these responsibilities.

959. In interview, a senior member of HBOS Finance indicated that both the Group CEOs had '*a low emphasis on risk*'. In his capacity as Chairman of the Audit Committee, Mr Hobson noted that Mr Crosby as Group CEO had held fewer meetings with him to discuss risk issues than when Mr Ellis had been responsible for risk '*…Mike* [Ellis] *came to every Audit Committee meeting. James* [Crosby] *came to maybe one or two. So it's really just a consequence of the interaction and the degree of interaction. So I can't – I knew exactly almost on a weekly basis where Mike was on lots of issues. I just didn't have that degree of interaction with James*.'

960. The often limited coverage of risk issues in the monthly CEO reports to the *Blue Book* was also notable and indicative of a low priority being placed on risk by both CEOs. For example, risk and control issues were barely mentioned at all in the CEO reports in the year leading up to the start of the financial crisis in mid-2007. Any control issues that were identified were usually played down as being dealt with. When risk was mentioned it was usually either to highlight threats to the firm achieving its balance sheet and profit growth objectives, e.g. '*Funding is the key risk to future growth at HBOS'* or in the context of updating on the firm's progress to Basel II compliance. Even when Basel II IRB compliance was partially achieved, it is notable that Mr Hornby's CEO report highlighted that the capital numbers would be co-presented in the *Blue Book* on a so-called '*realistic*' basis to eliminate '*underlying regulatory conservatism*', sending a message that senior management had little regard for the new regulatory regime and the risks it was intended to address.

961. The tendency to regard risks purely as a threat to achieving growth was also a tone set by both CEOs in the strategic planning process. For example, in the January 2007 Board Away Day pack, Mr Hornby identified a range of risks, such as the '*over-reliance on wholesale funding'*, as '*serious strategic weaknesses…to deliver superior growth to our competitors'* and that the goal of the Away Day was to '*address these challenges and devise ideas for future growth*'. As a result of this approach to risk, neither of the Group CEOs formulated an appropriate strategy for dealing with the Group's known weaknesses.

Tone from the Chairman

962. A key role of the chairman of an organisation, along with the other NEDs, is to act as a check on management, as well as to ensure that the right people are in executive roles. In the Review's assessment Lord Stevenson reinforced the culture of confidence and optimism and, at times, lost some of the objectivity the role required.

963. In HBOS's 2007 Annual Report and Accounts it states *'The remuneration policy for the Chairman recognises that, whilst the Chairman was independent of the organisation when he joined it, he is not now regarded as independent. The Chairman plays an active role in influencing the strategic direction of the Group and ensuring overall performance delivery. Therefore we believe that it is entirely appropriate that the Chairman's reward arrangements continue to be based on a mixture of a base fee and performance-related long term incentive'.*

964. In interview, Lord Stevenson, repeatedly stressed that he was a 'non-executive' Chairman, in the sense that he did not make decisions for the firm; a sentiment that both the CEOs and other Directors agreed with. He was, however, also described as '*very involved as a Chairman*'. In a 2007 letter to the FSA, Lord Stevenson said that he was '*part-time (but not non-executive)'* as well as regarding himself as *'legally responsible for'* and '*knowledgeable and well briefed'* about the business.

965. Some of the statements made by Lord Stevenson indicate that he shared the CEO's growth focus. During the midst of the financial crisis, for example, Lord Stevenson referred to HBOS as being *'commercially rather frustrated'*.

966. In the Review's opinion Lord Stevenson's correspondence with the FSA lacked independent perspective and objectivity from the business, particularly later on in the Review Period. In June 2007, for example, Lord Stevenson wrote to the FSA Chairman to challenge robustly the FSA's decision to reject HBOS's waiver application in relation to its corporate Basel II models. Furthermore, in an email dated January 2008 to Mr Hornby (copied to the FSA), Lord Stevenson reported that he had told the FSA that '*…HBOS has called the recent credit cycles certainly better than any of the UK banks and probably better than any of the world's top 20 banks…*' He also said that he had cautioned the FSA against making sweeping generalisations about the commercial property sector being applied to HBOS '*before having a detailed understanding of the, in my view, quite cleverly constructed HBOS involvement in property*'.

967. As the crisis took hold, the Chairman presented a bullish manner in correspondence between HBOS and the FSA. In an email to the FSA Chairman in March 2008, for example, Lord Stevenson stated that HBOS '*in a worrying and uncertain world is in a secure a position as it could be*' and that '*without wishing to be the slightest bit complacent, we feel that HBOS in this particular storm and given its business characteristics is in as safe a harbour as is possible …*'

3.4 Failings in the implementation of the risk management framework

3.4.1 Introduction

968. This section looks at the key failings in the implementation of HBOS's risk management framework during the Review Period which contributed to the failure of the firm.

969. The structure of the section is as follows:

- failings in the implementation of the 3LoD model, including a lack of ownership of the approach (see Section 3.4.2);
- failings by the Group Risk Director(s), the Group Risk function ('Group Risk') and the Executive Risk Committees, which were part of the second line of defence in HBOS's risk framework (see Section 3.4.3); and
- failings by the Audit Committee, the Risk Control Committees and Group Internal Audit, which made up the third line of defence in HBOS's risk framework (see Section 3.4.4).

3.4.2 Three lines of defence roles and responsibilities

970. As previously stated the 3LoD model operated by HBOS appeared appropriately designed for the Group and had been reviewed and endorsed in a 2004 Skilled Persons Report on *HBOS's Risk Management Framework* by PwC. However, there proved to be a number of weaknesses in the on-going implementation of the model which became increasingly apparent during the Review Period.

971. First, HBOS's application of the 3LoD model was designed more to suit its federal structure than its functional risk management objectives, and this weakened its effectiveness. Divisional risk functions were part of the first line of defence and, as highlighted in the FSA's Final Notice to the Bank of Scotland, 9 March 2012, they became too close to the performance objectives of their respective divisions. Moreover, the remuneration of these functions was aligned to the performance of the division in which they operated, which meant that their objectivity could have been compromised. The ineffectiveness of the Corporate Division's first line of defence was comprehensively addressed in the FSA's Final Notice to Mr Cummings, 12 September 2012, and so is not considered in further detail in this Report. Many of the serious failings within Corporate were also to be found within the Irish and Australia businesses in International; in particular poor credit sanctioning and monitoring.

972. The Review has considered the way HBOS assigned overall responsibility for the risk framework and the ongoing effectiveness of the three lines and has concluded that this was not effectively assigned within the Bank. In particular, assurance responsibilities were not clearly defined between the second and third lines. HBOS's Board Control Manual identified the CEO as having overall responsibility for the overall systems and controls operated within the HBOS Group. The GRD who reported to the CEO, had responsibility for *'group-wide risk management and oversight, the context of the overall systems and controls, which remained the responsibility of the*

CEO'. Furthermore the GRD was responsible for '*the day to day operations and maintaining an effective and efficient system of internal control…'*

973. The Review also considered that the responsibilities of each of the elements within the 3LoD were not clearly articulated or understood. A lack of understanding of the delineation between the different lines was the subject of concern throughout the Review Period and was raised on multiple occasions in internal reviews undertaken at the time.

974. A 2006 GIA Group Risk Review, for example, stated that there needed to be *'a better understanding of how the three lines of defence work together, in particular the 2nd and 3rd lines and their respective roles, as there is still considered to be significant overlap of work performed and confusion as to 'who does what and why'*. The Review also said that '*there was a general view expressed amongst interviewees that Group Risk's oversight role requires to be more clearly defined (as at present it varies by function) and communicated across the Group in order to help remove some confusion across the three lines of defence*'.

975. There is little evidence that these concerns were addressed. A 2008 an internal review of HBOS's Risk Management Framework similarly found that *'The principles of the 3 lines of defence model remain fit for purpose but there is scope to clarify roles and responsibilities'* and there needed to be '*Greater clarity on what functional leadership means for the Risk Community'*.

976. While there were a number of reviews undertaken to assess HBOS's Risk Management Framework, these did not appear to lead to an improvement in the effectiveness of HBOS's 3LoD Risk framework, such that when Mr Hickman presented a paper to the Board entitled Review of Risk Management in HBOS in July 2008, he highlighted a number of material weaknesses including the fact that HBOS's '*portfolio management is in its infancy and well behind our peers'*.

3.4.3 The second line of defence

Group Risk Director

977. The GRD should have played an important part in maintaining a robust control and risk management environment in the firm. However, the effectiveness of this role was undermined by the appointment of a succession of short-tenured, non-specialists to the role and the early departure of experienced staff from the risk area.

978. Ms Dawson was appointed the first GRD in January 2005. With a background in sales, Ms Dawson was not considered a risk specialist and her appointment was challenged by senior risk managers including Mr Paul Moore, Head of Regulatory Risk, and Dr Angela Smith, Head of Financial and Operational Risk. The investigation concluded that the GRD does not necessarily need to have strong technical competencies in the wide range of HBOS generic risk categories (e.g. market, credit insurance, operations, regulatory, liquidity, interest rates), if they are supported by individuals with the appropriate technical skills.

979. Mr Ellis retired in October 2004 (although he later re-joined HBOS as Group FD in September 2007), Mr Moore departed from HBOS in December 2004 and Dr Smith subsequently left in late 2005. This meant that the three most senior and qualified HBOS staff with responsibility for risk had left the organisation by the end of 2005.

980. Although Ms Dawson was of the view that she had a strong and capable senior team reporting to her, including specialist technical support provided full-time by the recruitment of a former partner from a large consultancy firm, it seems inevitable that the departure of the risk managers resulted in a loss of risk expertise and authority during this period.

981. Ms Dawson moved on to a more senior role in HBOS after around a year as GRD to be replaced by Mr Watkins. Mr Watkins in turn moved on after just 18 months to be replaced by Mr Hickman. Neither Mr Watkins nor Mr Hickman had a background in risk. The role of GRD was therefore held by three different non-specialists in three years. Although each person to hold the role was very well regarded within the institution and had considerable business experience, this high turnover and use of non-specialists at a senior level inevitably weakened the effective voice of Group Risk within the Group.

Group Risk

982. As well as being affected by the lack of clarity around the 3LoD framework, there is evidence to suggest that HBOS lost sight of some of the key facets needed to ensure the effectiveness of the risk framework, including providing effective challenge to the business. This meant that, when Group Risk did identify concerns, it did not always have traction with the business to ensure that improvements took place. A focus on meeting regulatory requirements, including Basel II compliance, may have also distracted Group Risk from its primary responsibility of acting as a check on the business and thereby reduced its effectiveness. The loss of risk expertise highlighted above is likely to have been a factor in these developments.

983. A 2004 PwC Skilled Person's Report on HBOS's systems and controls in regard to risk management was supportive of the risk management framework in HBOS but this support was predicated on the risk functions continuing to operate in a robustly challenging way: '*The devolved risk management structure operated by HBOS can only work effectively if the group oversight function operates in a rigorous and challenging way, there is transparency and openness in the relationship between group functions and Operating Divisions and the group functions have "teeth".'* However, the extent to which this robust challenge was maintained in the period following the PwC report is questionable.

984. Despite the fact that the GRD reported to the CEO and was a member of ExCo, Ms Dawson described Group Risk as acting more as an advisory rather than an oversight function. In her written submission to the PCBS, she stated that '*the nature of the* [Group Risk role]*…was not an authority, it was an influence*' and Group Risk '*did not… have the right of veto on any decision*'.

985. Mr Moore told the PCBS that the organisation had a '*cultural indisposition to challenge*'. Dr Smith highlighted difficulties challenging some of the divisional chief executives particularly '*the Business Banking division and the Corporate division*'. This latter sentiment was echoed by Ms Dawson who stated that '*the relationship between Group Risk and the Corporate division (led by George Mitchell until December 2005) was probably the most challenging of these*' though there '*was a wide expectation… that that relationship would be easier under Peter* [Cummings]'. Nevertheless, Mr Hickman who later held the role of GRD, said that Group Risk remained *'a much more effective sort of challenger to Retail than it was to Corporate*'. And as recorded in the FSA's Final Notice to Mr Cummings on 12 September 2012, the FSA found that *'risk management was regarded as a constraint on the business rather than integral to it*'.

986. There is also evidence to suggest that Group Risk (and GIA) did not have the capability to challenge some parts of the business. A member of the GIA leadership team remarked in interview on the lack of understanding within the Group of certain areas of the business: '*…The ISAF* [Integrated Structured and Acquisition Finance] *business was quite different in terms of the rest of the division probably didn't understand it… The only people who really understood that business worked in it. So that was a big control weakness as well*'. While this comment was refuted by the Managing Director of ISAF in interview, it was supported by a senior individual within Corporate risk assurance.

987. When Group Risk did raise concerns with the business, it seems that it was not always listened to, or followed through appropriately. Section 3.5.3, for example, highlights the fact that Group

Risk identified some of the weaknesses in the control environment in International, particularly HBOS's Australian operations, but did not get traction from the business to remediate the issues uncovered in its reviews. As set out in Section 2.11, there is also strong evidence to suggest that, at a working level, Group and Divisional Risk had raised significant concerns around the prudence of Corporate in late 2008, but faced difficulty persuading senior management (including the GRD and Group FD) to provision more conservatively.

988. In addition to concerns around the level of challenge, by Group Risk and the GRD, prioritising regulatory issues raised by the FSA could have impacted risk resource and lessened the function's ability to monitor the activities of the business effectively.

989. In interview, for example, Ms Dawson commented on the priorities as GRD given to her by the CEO in 2005: *'My clear understanding from him* [Mr Crosby] *from those discussions as to priorities, from a business perspective, first and foremost the FSA ARROW and the RMP… establishing the Basel programme was equal sort of number one priority*'.

990. From 2006, the focus of Group Risk moved increasingly to meeting the FSA's Treating Customers Fairly (TCF) requirements and Basel II related activities. The latter required the heavy involvement of Group Risk resource, particularly in helping Corporate to address data and modelling issues. The impact on Corporate was noted in a paper to the HBOS Board: *'Current* [Basel II implementation] *efforts were diverting attention away from the Corporate front line, and were not sustainable in the longer term'*. The Basel II project ran for a considerable part of the Review Period and was rated as 'red' by GIA for eight consecutive months in 2007 before it was eventually rated 'amber' in November 2007, as a result of HBOS responding to the FSA and IFSRA confirming all first-use conditions for the Advanced Internal Ratings Based waiver have been met.

991. Given the importance placed by HBOS senior management on achieving advanced status for its Basel II risk models because of perceived '*serious competitive benefits or reputational impacts*' and the difficulty HBOS faced in achieving this approval in Corporate (see Part 4 Section 4.6.3), it seems inevitable that some risk management resources were distracted from their core oversight responsibilities during this period.

Group risk committees

992. Poor data-quality contaminating MI was identified as an impediment to the effectiveness of the Group Risk Committees (GRCs). This was raised in the minutes of a number of GRCs, including as potential contributory factors in causing limit breaches. While one of the expected outcomes of the Basel II implementation project was to deliver improved MI, the Review has not seen any evidence of issues being allocated to an individual to resolve or of an agreed timeframe for monitoring and tracking resolution of the issues within the GRC's minutes, although some of them formed part of ongoing project issues and were included in the relevant section of the *Blue Books*.

993. In Corporate, there is evidence that the GRCs did not provide adequate challenge. For instance, sector limits were assessed by the GCRC but in such a way that they gave minimal constraint to lending. When limits were reached or breached they were typically raised, with insufficient consideration of the additional risk to the portfolio when sanctioning this.

994. In International, there is evidence that the GCRC and the Division's RCC provided some control but the committees' distance from the business in countries such as Australia, both in terms of geographic distance and knowledge of the local market conditions appears to have undermined their effectiveness (see Section 3.5.3).

995. Meanwhile, for Treasury, splitting the responsibilities of GALCO into two new committees in February 2006 created complexity, as highlighted in the balance sheet management illustration (see Section 3.5.1). The existence of multiple committees also increased the risk that balance sheet issues were addressed in silos. This risk was only partly tackled at the time by some commonality in the Committee's membership.

996. The Board appears to have taken comfort from the tone of reports to it over this period. Ms Dawson a member of HBOS Group Board at this time said in interview '*I would say the tone of reports from Group Risk to the Board over that period in relation to the Corporate business was one of a steadily improving business – one of a strong tone from the top, steadily improving risk infrastructure, good progress on the Basel work and strengthening risk management in that respect, but always more to do. And that would have been the summary pretty much of every report until, I think, sort of early 2008, from both Group Risk and Group Internal Audit*'.

997. More broadly, the absence of a group-wide risk committee (it met only once in January 2005) was a significant gap in the risk framework. It could have addressed one of the principal concerns of the Group, namely the failure to aggregate material risks across all the divisions.

Oversight of credit risk

998. Weaknesses existed in the first line of defence for credit risk. The Heads of Corporate and International in practice signed-off large loans in each other's Division; and the sheer volume of loans which needed to be reviewed and approved by the credit committees. Oversight by Group Risk was limited. It conducted its oversight of credit risk on a 'post-approval sample view' basis which tested whether the approval process had been followed by the business. GIA did not assess the quality of credit decisions because it held the view that the required expertise was in Group Risk or the business. These factors resulted in a fundamental gap in the oversight of credit risk and enabled the deteriorating quality of lending decisions in Corporate and International to go largely unchecked.

999. The GCRC received monthly portfolio reports which, amongst other things, set out divisional credit-quality at a high level. A more in-depth analysis was provided in the divisional quarterly portfolio reports, and the bi-annual portfolio reports provided by HBOS Australia, Ireland, Europe and North America (ENA), and Treasury. These reports set out the general credit risk environment, specific credit risks and the general credit quality by portfolio and sector. In interview, Dr Smith explained that '*deep dives*' were performed from time to time and, although Group Risk appears to have attended Divisional Risk and RCCs their role in such is unclear. Additionally Group Risk resources were stretched. Mr Higgins noted in interview that he felt the Group Risk function did not provide oversight to the extent that he had experienced in other institutions. While Ms Dawson commented that '*It was apparent to me that there was a lack of clarity around the whole oversight area*.'

1000. Increasingly, these gaps and weaknesses were recognised by the firm. In July 2008, for example, a report from Group Risk to the HBOS Board identified a range of weaknesses in the first and second lines of defence, stating that HBOS's '*credit risk capability lags the industry*'. It was too late at this point, however, for any improvements to have a material impact on the firm's future.

Group Finance Director

1001. The key responsibilities of the Group Finance function and the Group FD concerned the Group's capital management and allocation, and managing the Group's balance sheet. All of the Group FDs, from the merger onwards, had an opportunity to recommend to the Board that balance sheet growth should be limited until the liability side was appropriately addressed through a solid and sustainable funding capability. This influence could have been exercised through the strategic planning process. However, as highlighted in the balance sheet management illustration (see Section 3.5.1 this opportunity was not taken until the onset of the financial crisis.

1002. The Group FD also played a key role in the oversight of the implementation and the adequacy of group provisioning.

3.4.4 Third line of defence

Audit Committee

1003. The Review has identified several failings in the performance of the Audit Committee. HBOS's Group *Board Control Manual* states that the Chairman of the Audit Committee is responsible for ensuring *'the effectiveness and efficiency of the Audit Committee'*.

1004. The Chairman of the Audit Committee throughout the Review Period was Mr Hobson, who had considerable previous experience in the insurance industry. Of the six audit committee members during the Review Period, only Mr Mack had any operational banking experience and he arrived in 2007. As with the Board, this lack of experience in relation to banking may well have contributed to the weaknesses of the Group Audit Committee and its ability to effective challenge the business.

1005. An important example of weakness of the Audit Committee and the inadequate challenge provided by that committee was in 2008, when it failed to check the aggressive provisioning strategy being pursued by management with respect to Corporate.

1006. The summary style of recording Audit Committee meetings makes it difficult to ascertain what discussion took place at Board meetings and the level of challenge by the Audit Committee. The Audit Committee minutes seemed to mirror the upbeat messaging of the management presentations and reports to the Audit Committee. In particular, papers to the Audit Committee consistently gave the impression that all issues had been correctly identified and appropriate action was always being taken by management to address them. This messaging was then simply repeated in the Audit Committee minutes.

1007. KPMG told the FSA that having attended HBOS's Audit and some RCCs it *'felt HBOS's governance structure was good, there was good NED challenge, a good tone and the framework was better than elsewhere'*. However, KPMG also noted that it did have concerns about the culture and controls within Corporate.

1008. An example of the upbeat nature of messages presented to the Audit Committee was provided by the *Basel II implementation – Progress Update* in October 2006. This set out certain criteria for securing the move from 'Red' status to 'Amber' of the project. The paper noted that the programme had delivered against the criteria and 'Amber' status had been achieved. However, on closer inspection, the criteria do not appear to have been fully satisfied and there was a programme of activity *'agreed between the division and Group Credit Risk to address all of the areas of conditionality provided within the sign off'*. The paper also noted that there were additional differences in relation to capital calculations which were, at the time, not understood.

1009. It is also unclear how effective the Audit Committee was in tracking audit issues and in challenging persistent problems. In interview, a member of the Audit committee said that he thought issues were followed up: '*I have no sense of a failure to follow up, but I can't refer to a tracking document. But certainly my expectation, rightly or wrongly, would be that the Chairman of the Committee is the person who has to make sure that the things get onto the agenda and are followed up appropriately*'.

1010. Nevertheless, there does not seem to have been any sense in the minutes of exasperation or frustration from Audit Committee members when matters were taking a long time to resolve. For example, the reports on the Basel II project were rated 'red' for eight consecutive months but with no real adverse comment in the Audit Committee minutes. Further, the persistent 'red'-rating was only apparent if a reader looked back through all of the previous Audit Committee minutes. Although the Audit Committee packs did contain high-level data on outstanding audit issues, these data were of insufficient detail to allow issues to be tracked effectively.

1011. Another weakness of the Audit Committee's approach was that it tended to respond to matters that were brought to its attention, which resulted in a few big issues, such as Basel II, dominating its agenda. Important concerns were raised on various issues, including controls, impairment provisions and mis-selling. However, by not referring to what it considered to be the key risks, the chance that important and emerging vulnerabilities would be overlooked by the Audit Committee increased. This was particularly important given the Audit Committee's backward-looking bias despite its broader responsibilities for risk issues and the lack of another forward-looking risk committee with a Group-wide perspective elsewhere in the organisation.

Risk Control Committees (RCCs)

1012. In the 2004 Skilled Persons Report on HBOS Risk Management Framework, PwC noted that they had attended two RCC meetings, one at HBOS's Treasury and Insurance and the second at Investment Division's (IID), and had been '*impressed by the operations of the RCCs which provide good oversight for each of the divisions. As a result of the RCC structure the NEDs are closer to the businesses and to the issues arising than in many other similar organisations*'. However, the Review has heard evidence that suggests there was a lack of focus in some RCC meetings and the limited operational banking experience of some of the RCC's chairs reduced their ability to challenge, which may have impaired the effectiveness of these RCCs.

1013. In interview, Mr Hobson strongly supported the RCCs as being a vehicle for challenge and debate. He highlighted the benefits as including giving NEDs the opportunity to immerse themselves in one of the divisions; taking weight off the Group Audit Committee and thereby allowing it to focus on higher level issues; and giving executive directors the opportunity to see at first-hand what was going on in another division from a risk and audit point of view.

1014. The connection between the RCCs and the Audit Committee was impaired, however, by the fact that not all RCC Chairs sat on the Audit Committee. In particular, neither the chairs of the Retail RCC nor the Corporate RCC were Audit Committee members, despite the fact that Corporate and Retail were the areas responsible for HBOS's largest risk exposures. Criticisms of the RCCs by some former HBOS staff include a lack of the following: reporting structure; non-executive knowledge; and effective leadership given by the RCCs to the first line of defence. In interview Dr Smith said '*In general terms those committees were ineffective. .... challenge was not really possible. It just wasn't culturally doable*'. Dr Smith also highlighted a lack of challenge and real discussion at RCC meetings: they were described as '*very consensual meetings*' for which attempts were made to sort out issues in advance. Dr Smith also indicated that pressure was placed upon the second line of defence to '*come to a viewpoint with the divisions in order to get an acceptable position with the non-executive directors*'.

1015. It was also suggested that these meetings were made unmanageable by the large number of attendees; for example, Corporate Risk RCC had up to 20 attendees to its meetings. The NEDs also highlighted a lack of focus in January 2008: *'Risk Control Committees could usefully be more focused in terms of the issues that they cover. Their effectiveness would be improved by increased concentration on more significant issues'*. A member of GIA Leadership Team described the RCCs as quite formal events with presentation papers that were taken very seriously but also noted: '*I never really felt actually that the non-execs were totally into the business, totally really understanding some of the things that, some of the transactions that were being done. They were concerned, and would ask questions, but I think they were easily, kind of, placated*'.

Group Internal Audit (GIA)

1016. While GIA may have discharged many of its responsibilities during the Review Period in line with its remit, the Review, however, considers the decision to exclude credit decisions from its scope to be a mistake. A stronger GIA function might also have had greater influence on the businesses and been able to strengthen the control environment rather than observing, as it did, its deterioration.

1017. A review of GIA by PwC in July 2007 concluded that GIA fulfilled its mandate to provide core assurance services for HBOS and reasonable support to the Board of Directors in assessing the system of internal controls over day to day business operations. Areas of strength highlighted in the report were:

- the GIA function had strong support from the Audit Committee and the Head of GIA had unrestricted access to the Audit Committee Chairman;
- the GIA function was regarded by the business as an independent function;
- the audit process was well developed and was supported by an established training and professional development program; and
- GIA had undertaken themed reviews across the organisation, which provided a Group-wide perspective.

1018. The PwC report also identified areas for development, including:

- the interaction of GIA with the other lines of defence lacked clarity, resulting in a perception that GIA could be more effective in demonstrating value for the organisation and the level of assurance being provided against key existing risks, and as a result identify overlaps or omissions in the assurance programme;
- the reporting line of the Head of GIA to the Group FD was a potential threat to the independence of the GIA function (it recommended that GIA should report to the Group CEO);
- clarification to the business areas of the executive sponsorship and remits of the second and third lines of defence would assist GIA in address perceived imbalances within HBOS of the respective authority of Group Risk and GIA;
- greater coordination across the Group of issues and their resolution, together with more proactive input on risk and control matters in respect of key developments within the business, and for the GIA's plan to clearly identify where assurance is being provided by other areas as, for example, the business considered that assurance over credit risk was largely undertaken by Group Credit Risk, with no, or minimal, input by GIA;
- GIA should link its scope of assignments to risks so that its assurance findings could contribute to HBOS's risk assessment process, so that differences or new risks could be understood at an earlier stage and addressed in future plans; and
- there was little evidence of senior GIA managers' movement since the merger to take up senior roles in the business. GIA was not currently viewed as a mainstream element of a career path within the HBOS Group, which impacted on its ability to attract and retain new talent.

1019. The PwC Report also highlighted that the GIA function was under-resourced and less well qualified than equivalent bodies at similar organisations, finding that:

- it had 171 Full Time Equivalent (FTE) staff which '*is below average in our experience by 9% or 16 FTE*'; and

- '*typically, in leading Internal Audit functions, we note that over 80% of staff hold at least one relevant professional qualification – within HBOS this statistic is 68%*'.

1020. These sentiments were echoed by a member of the GIA leadership team: '*I don't believe I had adequate numbers and skills on my team to deliver the plan for the Corporate Division*'.

3

3.5 Practical illustrations of management, governance and cultural weakness

1021. This section sets out three illustrative studies that serve to demonstrate the failings of HBOS's management, governance and culture in practice. They cover: balance sheet management; the Corporate Division; and International Division.

1022. There is some duplication in the illustrations and the preceding paragraphs. This is unavoidable and deliberate. The purpose of these illustrations is to provide practical examples of the flaws in HBOS management, governance and culture. These build on each other to form a broad picture and demonstrate the messages and conclusions made.

3.5.1 Balance sheet management

1023. The Board of HBOS recognised that over-reliance on wholesale funding was a strategic weakness and had taken action to address this. The Board did not however appear to appreciate the potential threat this posed to HBOS's sustainability but viewed it more as a constraint on business growth. Mr Hodkinson's evidence to the PCBS supports this: '*…frequent references to our position in funding did not relate to any concerns about the short-term liquidity of the bank – things that might threaten the bank but to our ability in five to ten years' time to support growth…*'

1024. HBOS's Treasury reported to ExCo in 2006 that '*we have very limited long-term excess* [funding] *capacity*'(199), but in May 2007 it was reported to the Board that '*Treasury have made substantive progress … to increase our wholesale funding capacity*'. This indicates concerted efforts were being made by Treasury to source additional wholesale funding in order to support HBOS's longer-term growth targets.

1025. HBOS took action that was intended to slow the growth rate and change the composition of its wholesale funds, by attempting to increase customer deposits and lengthening their diversity and maturity profile, rather than looking to reduce its reliance on them in absolute terms.

Increasing customer deposits

1026. Deposit growth was targeted to make the customer banking divisions more self-funding. Deposits were not intended to replace existing funds but were seen as a means of increasing lending capacity and slow the growth of its wholesale funds. While HBOS had the ability to increase the volume of retail customer deposits it was concerned that these would not have the stability or longevity required, and it did not have a big business banking or solid current account franchise that it could leverage to obtain significant SME and commercial customer deposits. In addition HBOS was almost unique among the large UK banks in that it paid interest on all deposits held. The relative costs of this alternative funding prior to the financial crisis meant that wholesale funding remained attractive to HBOS. Furthermore, the growth rate targeted by

(199) ExCo were told by treasury in 2006 that the bank's wholesale funding capacity would be reached in 2009 under the current plan. However in May 2007 it was reported to the Group Board, as part of the Group Funding and Liquidity Strategic Review '*that the Group had sufficient funding capacity to support the growth in the Business Plan*' and that '*good progress had been made in increasing wholesale funding capacity…. But there was no room for complacency. HBOS continued to be highly dependent on wholesale markets – and more so that the peer group*'.

HBOS for customer deposits was less than that targeted for lending which meant that wholesale funds were required to finance the resultant funding gap.

Increasing the source and maturity profile of wholesale funds

1027. Diversifying the source and maturity of its wholesale funds was regarded as a positive step. Increasing the maturity profile of its wholesale funds improved the short-term liquidity, but the absolute amount of HBOS funds and the fact that the maturity profiles of the funding and the loans were not perfectly matched gave rise to a number of 'cliff-edges' whereby HBOS had to enter the wholesale funding market to replace the maturing funds. During the crisis the strategy quickly unwound as the longer-term wholesale markets reacted to the crisis earlier than shorter-term markets.

Reducing new lending

1028. HBOS did take steps to reduce growth late in the Review Period. However by this stage HBOS's funding requirement to support its existing book was very high. However, its stated strategy to lend through the market cycle in support of some of its existing clients created an obligation to continue lending to those clients as the market deteriorated and in some cases HBOS had committed lending facilities to its clients. This, together with deals already in the pipeline, led to increased assets and thereby the need for higher levels of funding.

Oversight

1029. The Board appeared not to appreciate the adverse consequences of HBOS's dependence on wholesale funding and that its high loan to deposit ratio made it an outlier in regard to other large UK banks, vulnerable to a downturn in the market and its balance sheet inherently unstable. It was only after the arrival of Mr Mack on the Board that these vulnerabilities were considered and the assertions of HBOS executives were questioned.

1030. The lack of understanding and oversight of the Board was compounded by weaknesses in the second line of defence. Capital management and allocation, and managing the Group's balance sheet were the responsibility of the Group FD and Group Finance function. Group Finance appears to have acted as '*compiler of numbers*' rather than a strategic sounding board. It looked at what capital was needed to be raised in order to fund business plans rather than if it was appropriate for the balance sheet to grow at the rate it was growing.

1031. As part of the business planning process, Treasury prepared Group funding and liquidity plans each year which outlined the funding requirements for the following five years. All the plans produced during the Review Period noted the growing reliance on wholesale funding. The plans showed that not only was this reliance increasing in line with asset growth, but the gap between the asset and deposit growth was also increasing. At the start of the Review Period, the minutes of the HBOS Group Board meeting in March 2005 stated that '*HBOS was structurally illiquid*'.

1032. The influence that HBOS's Treasury had within the Group is unclear. Certainly it was not helped by frequent changes to the reporting lines of the Head of Treasury Services, especially when this resulted in him reporting to a business head, a user of funding.

1033. In addition, reviews in 2007 of Treasury services and in 2008 of risk management noted that the committee structure in place to provide oversight was overly complex. In February 2006, HBOS had split the responsibilities of the GALCO between the Group Capital Committee (GCCO), its sub-committees and the Group Market Committee (GMCO). The GRD chaired the GMC and was responsible for asset and liability management. The Group FD chaired the GCC and was responsible for managing the Group's balance sheet. The complexity was compounded by the fact that the Group's Head of Balance Sheet Risk reported to the GRD. The recommendation of the two reports was to reinstate the GALCO.

1034. While the HBOS Board did recognise that over-reliance on wholesale funding needed to be addressed, it tended to be seen more as a risk affecting its business growth and therefore to be managed, rather than as a risk that potentially posed a threat to its survival. There were essentially three ways that this over-reliance on wholesale funding could have been addressed: decelerate asset growth; attract and retain more deposits; and extend the maturity of wholesale funds. The first two address the funding weakness and the third tackles the liquidity mismatch concerns. By focusing on the second and third options HBOS did not adequately address the funding weakness and the problem was compounded by asset growth.

Actions taken to de-risk the balance sheet after the failure of Northern Rock

1035. The firm's initial response in the face of the evolving business environment was reasonable. From the start there was clear appreciation that the constrained funding position required tough action on the asset side, with a clearly articulated escalation plan were events to prove worse than assumed. At this stage, the dislocation was assumed to be a temporary one.

1036. ExCo established a Contingency Planning Group (CPG), which met weekly and had *'the authority to take all steps necessary to safeguard the Group's position'*. The CPG's first priority was to gain a clear view of the Group's existing commitments and the range of realistic actions open to the Group.

1037. The CPG advised ExCo to immediately begin to de-risk the balance sheet by reducing asset growth. The minutes of ExCo's 18 September 2007 meeting noted that this was to be done *'without spooking the market'*. Some caution was justified from September 2007 some market practitioners had identified that HBOS may be more vulnerable than its peers.

1038. ExCo also made revisions to the HBOS Group Business Plan 2008 – 2012 to reflect the changing market conditions. The changes included: reducing targeted growth rates in Corporate to 7.2% and reducing asset growth in International to 13% year-on-year. These growth rates were viewed *'probably as low as the group should prudently go in terms of asset growth'*.

1039. The Group's overall asset growth however, continued at higher levels than planned, increasing the Group's wholesale funding needs. Further actions were agreed to reduce asset growth and increase deposits. Even so, asset growth in Corporate continued to be *'stubbornly ahead of revised target levels'*. This was in part due to the closure of the syndication markets leading to an inability to sell down, the decision to honour pre-existing loan commitments and the desire not to *'spook'* the market.

1040. It was only in March 2008 that Corporate was effectively 'closed to [new] business': – *'In March, the Corporate Board agreed to suspend underwriting except in exceptional circumstances'*.

1041. The effectiveness of CPG was hampered by weaknesses in HBOS's MI and in particular from Corporate which made modelling in relation to projecting levels of assets difficult. Its inability to influence the Divisions was evidenced by the delays in suspending underwriting and excessive focus on market perceptions.

3.5.2 Management and governance failings in relation to the Corporate Division

1042. This section illustrates the control weaknesses within Corporate Division and the impact of them. It then describes how the Group Board was made aware of the Division's strategies, many of the risks associated with those strategies, the increasing risk profile of the Division, the weaknesses in the corporate control environment and the build-up of pressures in the market.

Control weaknesses within Corporate Division

1043. During the Review Period there were stark illustrations that the capacity of front line systems and controls in Corporate had not kept pace with its rapid growth in loans. In mid-2007, the Division's Business Plan 2008-2012 stated: *'Our back office processes have not kept pace with the rapid growth in our business… we will undertake a detailed review of these processes and now require additional investment in our infrastructure to help ensure we have a platform to support the business going forward'*. In July 2007, the Division advised the FSA that it had a backlog of over 6,000 reconciliations in its Loan Management System. During ARROW meetings in November 2007, the firm set and the FSA agreed a deadline for remediation of April 2008. However, by May 2008 the backlog had grown to 12,000 due to an inability to cope with new and more complex loans. A review following a significant control failing in one of the Division's regional offices found that Corporate primarily relied upon directive controls with very little checking that procedures were being followed. Furthermore there were few preventative controls in place. A separate report by Internal Audit noted *'controls were found to be lacking and there was an over-reliance on colleague knowledge and integrity'*.

1044. Although there were a number of programmes and initiatives to improve Corporate's risk management, Corporate's Risk function did not provide appropriate oversight and challenge to the business and it failed to halt the high-risk profile that the Division had built up in its portfolios.

1045. The control issues affected the business in a number of areas, including the sanctioning of loans and their subsequent risk management. As set out in the FSA's Final Notice to Mr Cummings, 12 September 2012:

- there was no process for defining risk appetite, beyond high-level industry sector limits, and these were not used effectively to constrain growth;
- the sanctioning process included a single credit approach whereby individual sanctioning decisions were made without a detailed consideration of the impact on the wider portfolio;
- staff were incentivised to focus on revenue rather than consideration of risk;
- there was a culture of optimism which affected the attitude towards assessing credit risk in the course of loan approval, and resulted in a reluctance to refer stressed transactions to the High Risk team in HBOS responsible for dealing with such transactions;
- risk management was regarded as a constraint on the business rather than integral to it; and
- a significant part of the portfolio had not been risk rated or ratings were out of date.

1046. Moreover, HBOS focused on cash flows and the value of collateral taken as security was not regularly assessed. A one-off exercise in respect of the property investment portfolio in early 2008 resulted in the percentage of the portfolio having a loan to value (LTV) in excess of 100% increasing significantly from 4% to 14%.

1047. The main committees within Corporate tasked with looking at risk were the Corporate Board and Corporate Credit Risk Committee (CCRC). The Corporate Board's emphasis was on the business performance and operational management of the Division. Reports to the Board tended to focus more on the business units' profit and loss and growth rather than potential risks, although some risk issues were discussed. The CCRC saw irregular attendance by members of Corporate's senior management: Mr Cummings was the chair but only attended nine of the 34 meetings held from the beginning of 2006 to the end of the Review Period.

HBOS Group's Board view of risk management and control issues in Corporate

1048. Throughout the Review Period, the HBOS Board was made aware by the regulators, its external auditor and from internal reviews of the need to improve Corporate's control framework and to make sure its risk management capabilities kept pace with its growth. For example Group Risk papers to the Board in 2005, 2006 and 2007 all recorded that strengthening was required, but, internal messages were mixed and often appeared contradictory.

1049. Corporate's management stated that the Division was pursuing change with aims that included restructuring the Division to promote improved specialism and redesigning the risk environment, which in part was to be delivered in parallel with the implementation of Basel II. However despite the accepted need for change, Corporate's risk framework was consistently described as *'fit for purpose'* and in 2006 HBOS Group had an objective '*to turn superior risk management into significant competitive advantage*' (although this was later contradicted in a Credit Risk Review paper in May 2007).

1050. The Group Board placed considerable reliance on the experience and expertise of the Division's CEO and took comfort from statements the CEO made to it. However, other reports also seen by the Board appear to have indicated an alternative view. For example, in October 2007, Mr Cummings reported to the Board that '*there was no major over-hang of assets awaiting sell downs or securitisations within HBOS…*' and that asset quality remained strong. Yet, at the same time, reports to the Board showed that assets awaiting syndication had risen to £5.5 billion, as at July 2007 – up from £3.5 billion the previous year – while Corporate's MI showed that it was not actively seeking syndication of £1.7 billion of this amount at end September 2007, up from less than £1 billion in July 2007.

Corporate division's response to the changing business environment

1051. '*Historically, this* [Corporate] *business grew most quickly in a downturn, and became cautious as asset prices rose'* and accordingly it should have begun to slow lending in this environment in 2005. As the CEO had reported to Group *'Deals in both areas were being concluded by some competitors on unattractive terms. The Group would continue to turn away pricing structures that were too aggressive'*. In late 2005 the Board was told: *'…we have reached the stage of the cycle where it is now appropriate to be particularly selective in the business we choose to write and hold…'*

1052. In 2004-2005, the Division's stated strategy changed as the merger synergies were exhausted and there was some evidence of softening UK demand. The stated position became one of measured or controlled growth, albeit one in which the Division would still pursue opportunities.

1053. In 2006, the Division developed *'Asset Class Management'*. The stated approach in the 2006 published financial statements was:

- selective asset growth;
- a more focused approach in selected markets where the Division had experience and knowledge;
- controlled credit risk, to allow the Division to add to sectors where it was already a market leader and support strong growth in other markets; and
- cost control.

1054. In practice, Corporate's approach from 2005 to early 2007 was contrary to its philosophy and justifications were found for further growth. For example, an October 2006 Board paper noted that European leveraged markets were at historical highs, but that it was likely the market would keep lending until there was a destabilising event. The paper went on to say: *'We are able to compete against stretched entry multiples in this over-heated market because of our distribution capability…'*

1055. By May 2007, a general deterioration across most sectors and an increase in defaults was reported. Specifically '*commercial property is overvalued on an historical basis and we support the divisional view that the recent boom has run its course. A Market correction is expected, with capital growth likely to fall sharply in 2007 and possibly even reverse slightly during 2008/09'*. As the market worsened in late 2007, HBOS's appetite for new lending was unabated. In September 2007, for example, it was reported to the Board that *'certain mainstream rival banks* [that] *write business in some sectors (e.g. property) to securitise have effectively withdrawn from the market'*, HBOS's response was: *'Corporate will take advantage of lack of capacity/ appetite at some large lenders to re-establish a competitive advantage'.*

1056. In January 2008, Mr Cummings reported: *'This was not a repeat of the last commercial property recession, however, and underlying fundamentals remained robust. The Group's commercial property portfolio in the past few years had grown very modestly compared with the peer group, with very limited exposure to development risk'*. This statement clearly warranted challenge by the Board and ExCo based on known facts at the time: 22% net growth in loans and advances in 2007 could not be described as very modest and the Division had substantial (almost £10 billion) exposures to property development and house building. The Review has not seen evidence of such challenge.

1057. The philosophy associated with 'lending through the cycle' and 'supporting our customers' created a culture conducive to continued lending. So, even as there were general moves at Group level to restrain asset growth in late 2007 and early 2008, this did not filter down to the Bank's property lending activities until too late. It was only in March 2008 that Corporate was effectively *'closed to* [new] *business'.*

Group Board failure to control high-risk characteristics of Corporate's portfolio

1058. There is good evidence to suggest that HBOS Group Board was fully aware of the characteristics of Corporate's strategy and the control weaknesses in the Division. HBOS's Group Board should have been alert to the fact that Corporate's book could grow out of control, given its business model and market structure. While 2008 growth plans for the Division were reduced, the Group Board should have insisted on stronger action, including imposing proper discipline on the Division; especially given reports in October 2007 that the syndication markets had virtually closed.

Corporate's asset led strategy

1059. There were potential risks inherent in Corporate's asset led growth strategy. The strategy was known to be the lifeblood of the Division's profits and was always an aim, even as the market reached its peak. In 2006, Corporate said it aimed to *'build upon its excellent track record to deliver strong growth in both assets and earnings'* while in 2007, growth remained an aspiration: *'delivering high quality asset growth is a huge challenge'*.

1060. The Division's approach of underwriting large loans before trying to reduce its exposure through syndication was described to the Board in 2006. The importance of loan distribution for de-risking the balance sheet was highlighted in a May 2006 Board Credit Risk Paper. While a February 2007 Group Board paper noted that *'effective loans distribution is a key factor in delivery of the 2007 business plan in both de-risking leveraged deals…'* it also highlighted that the loans distribution capability of the Group needed development and the loss of capacity in other banks might lead to the retention of debt beyond the Division's risk appetite.

1061. When this forced retention happened in 2007, HBOS's response was to suggest that it had been the aim all along: *'Assets are originated on the basis that they will be held on the balance sheet in their entirety, even if subsequently a proportion of debt or equity positions are sold down to other market participants'*, stating that *'This discipline ensures there is no disconnect between a decision to lend and the potential availability of higher returns through sell down activity when market conditions are supportive'*.

Corporate's concentration in commercial real estate

1062. Commercial property was a core market for Corporate, where it viewed itself as having unrivalled strength and competitive advantage arising from its *'market leading insights'*, *'unique funding packages'* and *'expertise'*. As a result Corporate had a significant exposure to commercial property, both in absolute terms and as a percentage of its book. This was commented upon in papers presented to the Board, for example: *'Group Credit share Corporate's view that* [the property portfolio is] *a material concentration'*.

1063. Despite the historic highly cyclical nature of the commercial property sector and the size of HBOS's exposure to it, HBOS consistently describes commercial property as low risk: '*Strong collateral and sound lending criteria will maintain this as the best asset class in terms of credit experience*' HBOS asserted that *"quality was the key: expected losses through the cycle were very low. The Group's approach was of high quality* …..' As late as May 2008 Board papers were recording that impairments were low as at the end of 2007 *'…confirming our view that RE* [Real Estate] *sustains a low level of losses…'.* While some real estate may be lower risk, Corporate had significant exposures to the higher risk segments of construction, house building[200] and property development.

1064. Corporate's concentration in real estate was exacerbated by the fact that security taken on its commercial property lending proved inadequate when the market weakened.

1065. While the firm recognised that it had a concentration to property it regarded its portfolio as '*moderately concentrated'.* However, the risk was exacerbated by the large size of its market share and the nature of the market. With relatively few players in the market, and given the size of HBOS's exposures, there was limited capacity and liquidity to absorb any retrenchment by the firm (i.e. refinancing of loans as other lenders looked to leave the market).

Corporate's significant exposures to individual borrowers

1066. The ability to carry out bigger deals had been a rationale of the merger. In 2005, the Group Board was told that new lending parameters were encouraging larger property deals; while a 2006 credit risk paper noted an ongoing appetite for big deals. In 2007, a credit trends paper noted *'the trend towards underwriting larger high value private equity, infrastructure and property based transactions in the UK corporate market has continued*'.

1067. Corporate's ongoing desire to find new 'mega-deals' was highlighted in the April, May and June 2007 Board minutes and its strategy of fostering relationships with an entrepreneurial customer base was also known to the Board. Entrepreneurial customers were described as '*seasoned real estate professionals'* and an *'unrivalled talent base with which to operate'*. HBOS's approach was meant to give it a competitive and sustainable advantage with such customers: *'The integrated approach, and the Group's extended family of entrepreneurs continued to give competitive advantage'*; and *'our focus on leading real estate entrepreneurs differentiates us from our main competitors…'*

1068. The Group Board received monthly a schedule of approved facilities greater than £75 million, which showed a steadily lengthening list of increasingly high-value deals. In interview with the

(200) Though HBOS regarded lending to House builders as low risk given the long term structural under supply of houses in the UK.

Review, Lord Stevenson said that he and others on the Board were *'questioning a number of these big exposures, and there were a lot of them'*. Although in his interview as part of the FSA's Enforcement proceedings, Lord Stevenson said that the Board was provided with loan information *'just to let us know'*. The Review did not see evidence of such challenge from the Group Board against Corporate's broad policy of pursuing large deals.

Asset Quality

1069. Corporate's focus on sub-investment grade credits was another accepted strategy: Mr Hornby noted the book was 'by definition higher risk and lower credit quality'. This fact was highlighted to the Group Board in the October 2006 Strategic Review: '*Our core expertise and focus remains the sub-investment grade corporate business in the UK*'. From May 2007, it was even more explicit to the Board as credit trend papers consistently reported the average portfolio risk rating as '6.1' or 'B'.

1070. Despite this, Corporate's management asserted that asset quality was good and improving and that the strategic approach included a conservative risk appetite and sound credit quality. The HBOS Group Business Plan 2006 – 2010, for example, said that *'Our risk appetite remains positioned to cope with worse conditions, and we will continue to apply a conservative approach'*. Even in early 2008 the level of impairments was being used as a metric to assess asset quality; in interview, Sir Ron Garrick said '*the Board was being told we're* [Corporate are] *adopting a cautious approach'*.

1071. This caution was said to be evidenced by low or reducing levels of impairments. However, this could also be attributed to the market dynamics at the time, the possibility that the Division was operating at the top of a buoyant market, and that the high rates of churn, rapid refinancing and reduced covenants could mask poor asset quality. Furthermore, in February 2008 KPMG advised HBOS's Audit Committee that indicators had to be interpreted with care: *'…the additional asset growth, due to an increase in the portfolio awaiting syndication and less churn in the book as a whole means that these indicators should be interpreted with care. Had* [Corporate's] *asset growth been closer to plan, the deteriorating trend in impaired assets as a percentage of total advances and in the loss rate would have worsened…'*.

1072. HBOS's Board had no measures of risk appetite or tolerance against which to judge whether a risk was acceptable to it or how it might be changing over time: a September 2005 paper recorded that*'…the absence of a parameterised risk appetite (i.e. sector limits, portfolio risk grade distribution targets etc) may make us an outlier in terms of our peers'* while a 2006 Board paper recorded: *'The credit risk appetite for HBOS is presently taken to be the aggregate credit risk contained within the divisional business plans…'*.

Integrated lending model and risk capital (equity, mezzanine and junior debt stakes)

1073. The concept of taking equity stakes was a *'very long established Bank of Scotland principle'* according to Sir Brian Ivory and one which he *'fully supported'*. In March 2006, the Group Board minutes recorded that private equity was buoyant with no apparent limit to deal size and *'this gave rise to additional pressures for the group, as it was key to avoid over exuberance.'* In May 2006, it was reported that private equity continued to compete at historically high gearing levels and that, while performing well, would be susceptible to a general market downturn. In November 2006, the private equity co-investment strategy was explained to the Board.

1074. This approach, as noted in a paper to the September 2006 Board, would increase the Division's risk profile over time and reported a balance of £2.1 billion as being outstanding. This balance had risen to £3.1 billion by September 2007 and £4 billion by May 2008.

1075. Corporate's business model included the integrated finance approach championed by Integrated Structured and Acquisition Finance (ISAF), key aspects of which were not dissimilar to investment banking. This too was highlighted to the Board. For example, a strategic review of ISAF was presented to the Group Board in 2005, and which described an approach that encompassed a suite of preferred partners for whom the Division would go beyond the level of support provided to a casual partner.

1076. ISAF was seen as a success. It generated 40% of Corporate's profits with 5% of the staff and had a return on equity (ROE) of 51%, compared to a target ROE for the Group as a whole of 20%. HBOS believed the integrated finance model was unique and gave a clear competitive advantage to the firm: *'a clear and winning competitive strategy that had not been copied as yet by competitors – who appeared constrained by internal operational and other concerns'*.

Summary and conclusions

1077. In an October 2008 report to the Group Board, Mr Cummings acknowledged that *'…Corporate's performance* [would] *be significantly worse than our* [HBOS's] *main competitors'*, due to high exposures to commercial property, concentrations in single names, the integrated lending model and weaknesses in joint venture businesses. As is described above, none of these vulnerabilities should have been a shock to HBOS's Board.

1078. The Board was aware of the high-risk features of Corporate's portfolio, but appears to have failed to appreciate or challenge:

- the level of risk inherent in its strategy;
- the markets it was operating in, and the highly cyclical nature of these markets;
- some of the structural changes which were occurring in the commercial property market;
- the fact that Corporate's clients were in some cases operating in markets removed from their historical origins and what they knew and that they had been growing property portfolios in a benign environment, with no experience of managing through a downturn;
- the link between the nature of Corporate's business model, the rapid growth in assets; the move up the risk curve with external challenge about the sustainability of HBOS's business model;
- the FSA's views; and
- known weaknesses in Corporate's risk management and the difficulty it experienced in implementing Basel II (which included poor risk data).

1079. In interview, Lord Stevenson acknowledged that *'I think probably I personally had worried more about retail and insurance than I had done about Corporate – wrongly'*.

3.5.3 Management and governance failings in relation to International Division

Introduction

1080. In many respects HBOS's International Division appears to have been a microcosm of the HBOS Group as a whole in terms of its business model, structure and business profile, and as such the issues that the Review has identified by looking at HBOS's International Division serve to illustrate and highlight the issues that the Review found in the wider group.

Structure

1081. HBOS's International Division was different from, and more complex than HBOS's other Divisions as:

- it crossed business sectors, incorporating retail; corporate; investment and insurance; and Treasury businesses; and
- its Operating Divisions were located outside the UK and were often supervised by local regulatory authorities. For example, the primary regulator of Bank of Scotland (Ireland) (BOSI) was the Irish Financial Services Regulatory Authority (IFSRA).

1082. HBOS's International Division was, in effect, a collection of businesses rather than a single business unit. The only common feature of its Operating Divisions was that they were not located in the UK.

1083. HBOS's International Division was comprised of three Operating Divisions: Australia; Ireland and Europe and North America (ENA). ENA was itself a composite of a number of businesses operating in countries other than the UK, Australia or Ireland. HBOS (Australia) (HBOSA) and BOSI were separate legal entities. They were wholly owned subsidiaries of BoS plc (which itself was wholly owned by HBOS plc). The Operating Divisions were largely self-governed(201) through local Boards and managed by locally appointed Executives.

1084. International was the only division of HBOS that did not have its own Board. The CEO of International acted as interlocutor between HBOS Group Board and the Operating Divisions within International Division, through membership of the HBOS Board and attendance at the Operating Divisions' Boards and Audit Committees.

1085. The description of the structure of International Division and the role of its CEO suggests that the Operating Divisions worked with a significant degree of autonomy. However in representations received as part of this Review, the CEOs of Australia and Ireland stated that the Operating Divisions operated under significant constraints and controls imposed by HBOS's International Division.

1086. The governance, control and risk management frameworks of the Operating Divisions were approved by HBOS Group Board and were required largely to replicate the frameworks applied at HBOS Group level. For example, each of the larger Operating Divisions applied the 3LoD model similar to that of HBOS Group. UK-based teams and functions at International Division were considered to be within the first line of defence.

1087. Governance and control of International Division appear to have been conducted at several levels. Many Operating Divisions' function heads had dual reporting lines to their equivalent at International Division and to senior management of the Operating Division.

Strategy

1088. Broad direction was provided by HBOS Group Board through the group strategic framework. The focus was on replicating in the Operating Divisions what, at the time, was considered to be a successful UK business model. For example, a June 2007 HBOSA strategic review paper presented to HBOS's Group Board noted: *'HBOSA remains focussed on delivering increased profitability and market share in Australia, and in doing so, demonstrating the transfer of HBOS plc's core competitive advantages, providing additional growth options for the Group, and demonstrating that the HBOS formula can be successful outside the UK'*. Ambitious growth targets were a

(201) Describing the Operating Divisions as self-governed does not imply that they acted autonomously of the HBOS Group. It simply recognises that the Operating Divisions had their own Boards, Board Committees and locally based Executives who were responsible for the local business within the wider Group context.

consistent feature of the Group's strategic direction and this formed the basis on which the Operating Divisions developed their business plans and strategies. The local business plans were approved by the Operating Division's Board, aggregated in the UK to form the International Division's business plan and approved by HBOS Group Board following the culmination of the group business planning process.

1089. Growth in the International Division was strategically important to HBOS Group as it was seen to mitigate risks associated with its UK concentration (which was perceived by the market as a negative factor affecting HBOS's share price).

1090. Representations received as part of the Review indicate that the Boards of some key Operating Divisions initially (prior to the Review Period) raised concerns about the rapid growth being targeted and the levels of risk that the Operating Divisions would have to carry as a result. For HBOSA and BOSI this issue was of sufficient importance to the Boards, and in BOSI's case to IFSRA, that they sought and received parental guarantees and confirmation from the International Division that, other than required by local regulators, the Operating Divisions should operate not as separate entities, but rather as part of the HBOS group with risk being managed on a Group-wide basis and not in isolation on a local basis.

1091. The Operating Divisions' Boards appear to have derived assurance from the confirmation and guarantees received from the International Division (on behalf of HBOS Group). Analysis of HBOS Group Board meetings during the Review Period revealed that rapid growth was not raised as a concern by the International Division or its Operating Divisions.

1092. By design, HBOS's International Division did not manage or control the Operating Divisions within a single Divisional strategy or risk appetite. The *Board Control Manual* describes the overall responsibility of International Division's CEO as:

- to lead the strategy for the Operating Divisions and communication of matters affecting the Operating Divisions to both internal and external parties;
- to be responsible for leading the research and development of major strategic initiatives;
- to be responsible to the Board for the profitability and overall performance of each of the Operating Divisions;
- to be responsible to the Board for the overall system of control operated within the Operating Divisions;
- implementing Group Policies on risks and controls in each of the Operating Divisions;
- oversight of the day to day operations and maintenance of an efficient system of internal control, including financial, operational, compliance and risk management for the respective Operating Divisions that enables them to deliver their approved Business Plan and results within the risk appetite approved by the Board; and
- the approval of all high level major policy decisions in respect of each of the Operating Divisions in accordance with Group authority levels, Group Policies and Standards and within the confines of the overall Divisional Business Plans, subject always to prior consultation with the Chief Executive on matters which may have a material impact on other Divisions.

1093. The above list clearly indicates that the International CEO's responsibilities were at Operating Division level and he had no mandate to produce a single overarching strategy for the Division as a whole that would inform the Operating Division's strategies.

Operation

1094. Risks assumed by the Operating Divisions were to be considered in the context of the HBOS Group as a whole. Therefore levels of risk could be taken on which exceeded the level that was appropriate for each Operating Division on a stand-alone basis in the absence of full support of the HBOS Group. The Operating Divisions assumed that portfolio reviews were being undertaken by HBOS Group, based on information they provided. However it was acknowledged in 2006 that, for example, in terms of concentration risks *'challenge is provided by GCRC, but at present too much is post-event for this to be wholly successful'*. In addition as acknowledged at the time, HBOS had limited capability to aggregate risk information across all HBOS Divisions.

1095. This together with the fact that there was no overarching International Division strategy and no single group risk appetite increased the difficulty in assessing risk at a Group or International Division level.

1096. The ownership of and responsibility for key risks and the linkage between the International Division's UK-based risk functions and their equivalents in the Operating Divisions were not clear. For example, in regard to credit sanctioning, any new application for loans exceeding a pre-determined value or of a higher risk grade was to be assessed and approved by the International Division's UK-based credit team. However, there appears to have been some confusion as to what the assessment actually entailed. Representations received from the International Division's CEO and the CEOs of the Australian and Irish Operating Divisions indicate their perception that the International Division's UK-based credit team was undertaking full and thorough credit assessments of every request for approval. However, the Review was told that this team only ensured that lending was in line with broad criteria, with most of the credit assessment undertaken by the relevant Operating Division.

1097. The Operating Divisions appear to have been given a mandate to grow their businesses and operate in a manner which recognised the considerable resources of the UK Group. In this regard it was acknowledged that the nature and size of risks accepted may be in excess of those appropriate to the Operating Division as a separate entity. This is evident in the behaviour the Operating Divisions displayed in risk selection. For example, a recommendation to HBOS Group Board in November 2007 to increase the portfolio guarantee to BOSI appears to have been driven by a need to overcome sectoral constraints imposed on capital by the IFSRA in order to support BOSI's growth in the real estate market. This would increase HBOS Group's exposure to the Irish real estate market and its concentration risk to this market.

1098. HBOS Group Board received regular reports on the International Division. Strategic reviews gave the impression that Operating Divisions were successfully implementing the UK business model overseas and achieving strong growth and performance. However, in interview Ms Dawson said '*We* [HBOS Group Board] *had reports….from the Chief Executive of the International businesses, which often spoke about our success in winning large share of business …. we hadn't realised that we were succeeding potentially not because of superior skills but because of adverse selection*'.

1099. Under the strategic direction from HBOS Group to achieve asset-led growth and having been given assurances from the centre that risk was being considered on a Group-wide basis, the business plans devised at Operating Division level targeted what was at the time described as aggressive growth and the continuing acquisition of market share. These were the criteria against which their performance was assessed.

1100. With an emphasis on growth and limited focus on risk, it is not surprising that reviews of Operating Divisions throughout the Review Period identified weaknesses in risk management and risk management information, for example:

- In 2005, reviews of HBOSA by the FSA and later by HBOS Group Risk identified that risk resources were stretched and were unlikely to be able to cope with the planned expansion. Similar findings were found in BOSI.

- In May 2005, HBOS Group Board reviewed a number of papers related to Ireland. Two of them, a quarterly credit trends report and a separate paper on Group Credit Risk both produced by Group Risk, raised concerns around the level of credit knowledge, resource, and systems and controls to support growth plans. In contrast, a third by the CEO of BOSI stated '*BOSI has taken advance steps to ensure effective risk management commensurate with this level of expansion'* which appears to suggest that the issue had been dealt with. This apparent contradiction should have prompted some challenge.

- A September 2005 Board paper noted: *'The ability to provide high quality management information for both Australia and Ireland remains a significant issue'*.

- Early in 2006 Group Risk reported that it was '*…very evident that significant progress has been made since the RMP visit earlier this year* [2005]…' but there were still challenges to build the appropriate capability to support the growth plans.

- A May 2006 Board paper from the Risk function noted on BOSI that *'although the current level of arrears for each portfolio is monitored, there is a risk that problems could be disguised by rapid growth and the relatively high proportion of immature business. This can be mitigated by the quality and sophistication of available management information, which although now an area of significant focus still lags the standard seen elsewhere in the group'*, and '*the ambitious growth plans and the attack on new markets imply the need for a step change in the ability to rate, price and monitor risk. In some areas the desired level of capability is lagging the asset growth…'*

- A paper presented by HBOS's GRD at the June 2006 HBOS Group ExCo Away-Day titled *'Risks to the Business Plan'* notes under the section on the International Division: *'We are aware of the risk of rapid expansion that could arise through credit risk. Additionally, we face a number of operational risks, including systems/process (ability of existing/ legacy systems to cope with volume increase and/or product development) …'* It added: *'The businesses are well aware of these risks, but expansion must be adequately supported from an operational perspective'*.

- By year-end 2006, KPMG considered that, overall, there had been an '*improvement in the control environment across the Group'* as there had been no 'category 1' failings that year. KPMG observed a particular improvement in the International Division: '*the Australian process has considerably improved year on year. The Irish results were good and there had been very few pressure points in terms of the audit … The Europe and North American banking business was in good shape'*.

- In May 2007, however, it was again noted by Group Risk that BOSI and ENA had *'some way to go in developing appropriately granular MI to manage portfolios effectively at a Group level'*.

1101. The risks attached to rapid growth were consistently highlighted, but generally do not appear to have led to any significant restraint in the Operating Division's plans. It would appear that a combination of the apparent success of the growth plans and that development and remedial action was being taken served to hide the fact that controls were significantly lagging and ultimately were found wanting. The focus on Basel II (while being part of the driver to improve data), the remoteness of certain locations and general weakness in Group Risk (see Section 3.4.3) also contributed to the failure of the group functions to appreciate the deficiency or the gaps in risk management capability.

1102. This Review has not reached a conclusion as to whether the federal model which appears to have been operated within the International Division was appropriate. Nor does it need to do so to tell the story of the failure of HBOS. However it is clear for such a model to operate effectively, it would be vital for both the International Division itself and the branches and subsidiaries operating in other jurisdictions, to have clearly defined responsibilities. This would be particularly important in the context of setting limits for loans which could be sanctioned in-country, and which part of the organisation would be responsible for carrying out detailed credit assessments of potential customers. As set out in this section, in the case of HBOS there appears to have been a difference in view (which we have been unable to resolve through the contemporaneous documents we have seen) as to the respective roles of the International Division and HBOS's in-country operations in this regard.

Part 4
FSA supervision

4.1 Introduction

1103. This Part describes the overall regulatory philosophy of the Financial Services Authority (FSA) during the Review Period and considers the implications this had for the effectiveness of the FSA (Section 4.2). It describes how the FSA's overall approach shaped the intensity of the prudential supervision of HBOS's banking activities, the relationship with the firm and the resources devoted to it (Section 4.3). Supervision of HBOS's Insurance and Investment business, joint ventures and conduct issues are outside the scope of this Review.

1104. This Part then considers the supervisory approach to each of the main factors, described in Parts 2 and 3, that contributed to the failure of HBOS:

- asset quality (Section 4.4);
- liquidity and Treasury assets (Section 4.5);
- capital (Section 4.6); and
- management, governance and culture (Section 4.7).

1105. Consistent with *The RBS Report*, this Report does not consider the actions taken by the other Tripartite authorities (the Bank of England and HM Treasury) prior to, and in response to, the financial crisis. This section does, however, examine the contingency planning work undertaken by the FSA during HBOS's last year (Section 4.8). This area was not covered in *The RBS Report* as the FSA did not engage in any contingency planning for RBS.

1106. We have inevitably applied hindsight in forming our views. In doing so we do not imply any wrongdoing on the part of those involved by reference to the standards of the time and we are not suggesting that what is clear in hindsight was necessarily clear to those involved at the time. However, where we judge that decisions made were poor at the time, the Report makes this explicit.

4.2 The FSA's philosophy and approach to supervision

4.2.1 Introduction

1107. During the Review Period, large retail groups, such as HBOS, that could have a high impact on the achievement of the FSA's objectives were supervised in the FSA's Major Retail Groups Division (MRGD). This division reported to the Managing Director of Retail Markets, a position held by Mr Clive Briault for the majority of the Review Period.(202)

1108. The process by which the FSA implemented its supervisory approach consisted of the following:

- ARROW framework(203) – a periodic assessment of the risks which a firm posed resulting in an ARROW letter to the firm setting out the FSA's view of those risks.

- Risk Mitigation Programme (RMP) – a document which accompanied the ARROW letter detailing the actions required by the firm to reduce the identified risks.

- 'Close and continuous' (C&C) supervision – a description of the FSA's approach to the supervision of high impact firms. It included a planned schedule of meetings with the firm's senior management in order to assess progress in addressing the risks identified during the ARROW process and to identify newly emerging risks.

- Thematic reviews – which examined a particular issue across a number of firms (see Box 4.7, '*FSA Thematic work*').

- Baseline monitoring – during the Review Period, the FSA centrally(204) monitored regulatory returns, including those relating to capital and liquidity. Breaches and other indicators of risk were reported to supervisors who were responsible for pursuing them.

1109. Before examining how HBOS was supervised, this section considers the FSA's overall philosophy and approach to supervision during the Review Period. The structure of this section is as follows:

- the context within which the FSA operated (Section 4.2.2);

- the FSA's approach to supervision (Section 4.2.3); and

- the role of the FSA Board and Executive Committee (ExCo) (Section 4.2.4).

(202) See Appendix 9 for an overview of the FSA's executive management and Board during the Review Period.
(203) ARROW (Advanced Risk Responsive Operating framework) was FSA's methodology for assessing (i) the impact a firm posed to the achievement of the FSA's statutory objectives and (ii) the probability of risk crystallising.
(204) A central department was responsible for ensuring firms submitted returns to the FSA. It undertook basic checks on those returns and referred more detailed queries to the firm's supervision team.

4.2.2 Regulatory and political context

1110. Throughout the Review Period[205], the FSA had four statutory objectives, set out in the Financial Services and Markets Act 2000 (FSMA):

- *market confidence*: maintaining confidence in the financial system;
- *public awareness*: promoting public understanding of the financial system;
- *consumer protection*: securing an appropriate degree of protection for consumers; and
- *reduction of financial crime*: reducing the extent to which it was possible for a business carried on by a regulated person or in contravention of the general prohibition (on carrying out regulated activities without permission) to be used for a purpose connected with financial crime.

1111. It was also required to 'have regard to' the following 'principles of good regulation':

- *economy and efficiency*: that the FSA needed to use its resources in the most efficient and economic way;
- *senior management responsibility*: that a firm's senior management was responsible for its activities and for ensuring that its business complied with regulatory requirements;
- *proportionality*: that a burden or restriction which was imposed on a person, or on the carrying on of an activity, should be proportionate to the benefits, considered in general terms, that were expected to result from the imposition of that burden or restriction;
- *innovation*: the desirability of facilitating innovation in connection with regulated activities;
- *competitiveness*: the international character of financial services and markets and the desirability of maintaining the competitive position of the United Kingdom; and
- *competition*: the need to minimise the adverse effects on competition that might have arisen from anything done in the discharge of the FSA's functions, and the desirability of facilitating competition between those who were subject to any form of regulation by the FSA.

1112. These statutory objectives and principles applied when the FSA was discharging its 'general functions', which were:

- making rules under FSMA;
- preparing and issuing codes under FSMA;
- giving general guidance; and
- determining the general policy and principles by reference to which it performed particular functions.

1113. The FSA aimed to meet its market confidence and consumer protection objectives through a combination of conduct and prudential regulation and, as an integrated regulator, it did not have to draw a clear dividing line between the two disciplines. With such a wide remit, however, the

(205) In 2010, the public awareness objective was removed and a new financial stability objective – contributing to the protection and enhancement of the stability of the UK financial system – added.

Board and executive management(206) did have to make choices about how to prioritise the FSA's limited resources.

1114. There was a general belief prior to the financial crisis that the FSA's approach to supervision was appropriate and a model of good regulation. This view was reinforced by external assessments such as the National Audit Office's (NAO) review of the FSA in April 2007, which found that: *'The FSA is highly regarded within the financial services industry in the UK and internationally and its risk–based approach is increasingly seen as a model to follow by other regulators'*.(207)

1115. As set out in *The RBS Report*, the FSA's philosophy and approach to supervision prior to the financial crisis was set within a context which included:

- a sustained political emphasis on the need for the FSA to be a light-touch regulator in order to retain the international competitiveness of the UK's financial system. For example, at the launch of the Better Regulation Action Plan on 24 May 2005, the Chancellor said in a Treasury press release that: *'…the new model we propose is quite different. In a risk based approach there is no inspection without justification, no form filling without justification, and no information requirements without justification. Not just a light touch but a limited touch'*(208)*;*

- a consensus among practitioners and policy-makers that financial innovation and complexity had made the financial system more stable at a time of benign economic conditions. In this climate, very few people in positions of responsibility in major regulatory authorities or central banks appreciated the growing risks and several argued authoritatively that the risks had reduced.(209) We now know that this financial innovation and complexity played a significant role in the failure of the overall system; and

- the need for the FSA to regulate within established global regulatory standards on capital and liquidity.

1116. Furthermore, the FSA's precise statutory role in relation to financial stability was unclear. No specific statutory objective was defined during the Review Period(210), but a Memorandum of Understanding (MOU) between the Tripartite authorities established a framework(211) for co-operation in which the FSA's responsibility for micro-financial stability was an input. In addition, the FSA, in considering its market confidence statutory objective, did consider issues relating to financial stability(212) and would have had the data to assist it in identifying systemic risks. However, it did not consider macro-financial stability factors in a way that would now be considered appropriate. In its February 2011 paper, '*A new approach to financial regulation:*

(206) FSA 'executive management' refers to the members of the FSA's Executive Committee (ExCo) and included the Chief Executive and Managing Directors. A table of ExCo members during the Review Period is included in Appendix 9.
(207) The NAO Report is available in full here: http://www.nao.org.uk/publications/0607/financial_services_authority.aspx. At the time of its publication, the then Economic Secretary to the Treasury stated that: 'The independent NAO report shows that the FSA is working well, and is a world leader in a number of areas – which can only be good for the competitiveness of the UK financial services sector'. See the HM Treasury Press Notice dated 30 April 2007:
http://webarchive.nationalarchives.gov.uk/20100407010852/
http://www.hm-treasury.gov.uk/press_50_07.htm
(208) The full speech can be found at:
http://webarchive.nationalarchives.gov.uk/20100407010852/http://www.hm-treasury.gov.uk/better_regulation_action_plan.htm.
On 26 October 2006, in response to an oral question in the House of Commons, the Chancellor said that '…with the new City task force we will continue to found our policy for competitiveness on thinking globally, investing in skills, a competitive business and light-touch regulatory environment'. The full transcript can be found at:
http://www.parliament.the-stationery-office.co.uk/pa/cm200506/cmhansrd/vo061026/debtext/61026-0001.htm
(209) See International Monetary Fund (IMF) Global Financial Stability Review April 2006.
(210) The FSA did not have a separate statutory objective in respect of financial stability until it was added by the Financial Services Act 2010.
(211) The framework for cooperation between the Bank of England, HM Treasury and the FSA in the field of financial stability was established in the MOU of 28 October 1997, following the formation of the FSA. The MOU was revised in March 2006 to reflect developments including responding to a crisis threatening financial stability. Further details on the terms of engagement under the Tripartite MOU issued in March 2006 are on the FSA website:
http://www.fsa.gov.uk/pages/Library/Communication/PR/2006/025.shtml and http://www.fsa.gov.uk/pubs/mou/fsa_hmt_boe.pdf
(212) As set out in Section 1.2.5 of *The RBS Report*, from September 2007 the FSA, and in particular the Chairman, stressed the significance of deteriorating liquidity conditions, and raised issues relating to overall policies on public liquidity support. These issues were discussed in detail at the September 2007 meeting of the FSA Board and the FSA Chairman made the other Tripartite authorities aware of his concerns.

building a stronger system', HM Treasury recognised the fragmented nature of the Tripartite framework under which HM Treasury, the Bank of England and the FSA were collectively responsible for financial stability. The paper stated:

'... *this fragmentation of responsibilities has had a number of dysfunctional results. For example:*

- *the Bank of England, while having statutory responsibility for financial stability, has only limited tools to deliver it;*
- *the FSA, by contrast, has regulatory tools for delivering financial stability, but with such a wide mandate prior to the crisis – including consumer protection, public awareness, market confidence and the reduction of financial crime – was not sufficiently focused on stability issues; and*
- *perhaps most significantly, the linkage between firm-level and systemic stability issues has fallen between the institutional cracks, with no one body having the remit to tackle this fundamentally important issue. This has created a significant area of regulatory 'underlap' within the UK's framework.*'

1117. Within this context, it was inherently unlikely that senior leaders of the FSA would have proposed, before the first signs of the financial crisis (for example, before summer 2007), a supervisory approach which entailed higher capital and liquidity requirements, supervisory caps on rapid bank balance sheet growth, or intensive analysis of asset quality. If they had, it is likely that their proposals would have been met by extensive complaints that the FSA was pursuing a heavy-handed, 'gold-plating' approach which would harm London's competitiveness.

1118. However, it is now clear that the FSA's pre-crisis approach to prudential supervision was not appropriate for the purpose of meeting its market confidence objective.

4.2.3 The FSA's approach to supervision in the pre-crisis period

1119. The FSA's high-level approach to the supervision of systemically important firms in the pre-crisis period was sound:

- A 'risk-based' approach: this was designed to identify the main risks to the FSA's statutory objectives as they arose, measure their importance and mitigate those risks where their significance justified this. Key risks were identified within the FSA's *Financial Risk Outlook* (*FRO*). In assessing individual firms, the scale of risks was quantified as the product of their impact (the potential harm that could be caused by particular events) and probability (the likelihood of the events occurring).(213) This was used to provide a measure of the overall risk to the FSA's achievement of its statutory objectives. The nature and extent of the FSA's supervisory relationship with a firm, beyond the articulated minimum level of supervision, depended on how much of a risk to those objectives the firm was considered to pose.
- A 'principles-based' approach: from early 2006, the FSA increasingly focused on achieving desired regulatory outcomes more through principles rather than through detailed rules. The expectation was that firms' behaviour would improve with this shift in emphasis. An example of how the principles-based approach was used was in the FSA's Treating Customers Fairly (TCF) initiative.

(213) Impact was primarily calculated using numerical data from a firm's regulatory returns. Probability was assessed through consideration of the gross risks inherent within a particular product, line of business, sector or firm before separately considering the quality of controls in place to deal with those risks. The effectiveness of the control functions and management, governance and culture at the firm were also assessed, as well as other specific mitigants such as the amount and quality of available capital and liquidity at a firm.

1120. However, the approach was undermined by the emphasis on light-touch regulation and the perception that the economic outlook remained benign. The FSA also operated within a tight budget[214] and with limited resource. Against this backdrop, FSA executive management set a strategy which had the effect of reducing the pressure on firms in the pre-crisis period. This approach entailed:

- Placing reliance on a firm's senior management and control functions: supervision would allocate actions from the RMP to the firm, as opposed to the FSA or an independent third party, in line with the degree of reliance it felt it could place on the firm's management and control functions. Supervision would request confirmation that the actions had been undertaken but the level of supervisory follow up would be based on judgements about the amount of reliance that could be placed on the firm and the perceived importance of an issue.

- The potential for firms to earn a 'regulatory dividend': introduced in 2006, this approach entailed a less intensive approach for firms that cooperated with the FSA and maintained an effective governance and control framework. It also included a specific initiative to close items on the RMPs of those firms assessed to be the most receptive to the FSA's C&C approach (see Section 4.3.8, '*Supervisory relationship with HBOS*').

1121. Prior to the financial crisis, the FSA's approach to supervision was deficient in a number of ways:

- The FSA's approach to supervision was poorly executed. In early 2006, the FSA revised its approach to ARROW assessments. The introduction of the ARROW II process was designed to integrate all the supervisory frameworks and make better use of thematic work and sector intelligence. It was also built to enable flexibility according to risk appetite and allow FSA resources to be applied where they would make the most difference. However, in its execution this initiative resulted in too much focus on process rather than substance.

- Beyond the high-priority given to Basel II and risks highlighted in the *FRO*, the FSA Board and executive management failed to set a clear prudential strategy (see Section 4.2.4, '*The role of the FSA Board and ExCo*'). This reflected the widespread belief that the global economy and financial system had become more stable.

- The level and experience of supervisory resource devoted to large, systemically important firms was inadequate to support the judgements taken under the ARROW II approach. Consequently, the FSA placed too much reliance on a relatively high-level risk assessment of the main issues affecting high impact firms and the FSA's statutory objectives, with insufficient detailed review and direct testing carried out to inform supervisory judgements in key risk areas.

- Skilled Persons Reports by external third parties tended to be seen as a pre-enforcement tool at that time, so were rarely used and did little to alleviate the pressure on limited supervisory resource (see Box 4.1, *FSA use of Skilled Persons Reports*).

- The FSA was primarily reactive in the absence of indicators of heightened risk. As a result, the FSA's approach encouraged a culture where supervisors placed undue reliance on assurances from firms' senior management and boards about governance, strategy, business model and key business decisions. It also led to too much reliance being placed on the firm's control functions to identify and address issues.

- FSA executive management did not define it as part of supervision's role to criticise a firm's business model and FSA staff were told that they should not get into the position of being

(214) The FSA's budget for ongoing regulatory activities during the Review Period was as follows: 2005/06 £284.9 million; 2006/07 £302.5 million; 2007/08 £328 million; 2008/09 £361.6 million.

shadow directors.(215) As a result, supervisors did not always reach their own judgements on the key business challenges and strategic risks in firms' business models, based on in-depth, rigorous review. Without in-depth analysis of a firm's strategy, the supervision team's ability to assess the adequacy of the underlying control framework was undermined. FSA staff could have done this without acting as shadow directors.

- Although there was recognition within the FSA that the liquidity standards were deficient, and despite some attempts by directors and heads of department to raise concerns, there was no appetite by executive management to supplement international standards for fear of accusations of gold-plating.

Box 4.1: FSA use of Skilled Persons Reports

Section 166 of FSMA gave the FSA the power to commission reports by Skilled Persons (external third parties). This tool was typically used to obtain an independent view of aspects of a firm's business which caused concern to the FSA. During the Review Period, Skilled Persons Reports were used on an exceptional basis when the FSA did not have sufficient resource or expertise internally to investigate a particular issue of concern.

Although not explicitly described as such, Skilled Persons Reports tended to be regarded by both regulator and regulated as a pre-enforcement tool. The FSA's policy on the use of Skilled Persons(216) emphasised a firm's track record as an important consideration in deciding whether to use the tool, rather than allow the firm to conduct its own enquiries. Relevant factors included whether:

- the firm was being co-operative;
- similar issues had arisen in the past and, if so, whether timely corrective action was taken; and
- the FSA had confidence in the firm's willingness and ability to deliver an objective report.

Before deciding to use this tool, supervisors were also required to consider whether the cost of the report was proportionate to the firm and to the specific or potential risk.

In line with FSA guidance(217), it was usual practice for Skilled Persons to be nominated by the firm but the FSA was required to approve formally the appointment. Skilled Persons included, but were not limited to, accountants, auditors, actuaries, lawyers and IT consultants.

Statistics on Skilled Persons Reports commissioned by the FSA

Year	Cases
2004/05	19
2005/06	17
2006/07	18
2007/08	29
2008/09	56
2009/10	88

Use of the tool by the HBOS supervision team

A Skilled Persons Report was undertaken by PwC in respect of HBOS's risk management framework in 2004 (see Section 4.7.4, Box 4.9).

(215) Michael Foot (FSA Managing Director, Deposit Takers & Markets Directorate, 1998-2004) in evidence to the PCBS said: 'we certainly told our staff very clearly that they would never get in the position of being shadow directors'. John Tiner (FSA CEO, 2003 – 2007) in interview with the Review Team: 'I had, you know, Howard Davies and Michael Foot and other members of the [FSA] board telling me almost every day, "Be very, very careful that you don't become a shadow director"'.
(216) As set out in the FSA Handbook, SUP 5.3.
(217) FSA step by step guidance to appointing a Skilled Person.

Other reviews were carried out by external parties during the Review Period. Although formal powers were not used by the FSA in relation to the following reviews, the findings informed the supervision of HBOS:

- KPMG's review of Mr Moore's whistleblowing allegations in 2005 (see Section 4.7.4, Box 4.10);
- KPMG's review of HBOS's collective provisioning policy in Corporate in 2005 (see Appendix 4, PCBS question 4); and
- PwC's review of Group Internal Audit in 2007 (see Section 4.7.4).

1122. As described in *The RBS Report*, the lack of resource was further exacerbated by the organisational structure that the FSA had in place during the Review Period. The FSA had an integrated approach to supervision, whereby supervision teams were responsible for both conduct and prudential issues and banks and insurers were supervised in the same division, such as MRGD, and sometimes the same department within the division. With the exception of Basel II implementation, priority was largely given to conduct issues in the absence of a clear prudential strategy, given the prevailing belief about the stability of the financial system. As a result, there was inadequate focus and resource on the core prudential issues of asset quality and liquidity. See Section 4.3.6, '*Supervision team resources and turnover*' for more detail on the level of supervisory resource for HBOS. From March 2008, the FSA embarked on a programme of change to tackle the deficiencies in its approach to supervision, including resourcing, known as the Supervisory Enhancement Programme (see Box 4.2).

Box 4.2: The FSA's Supervisory Enhancement Programme

On 26 March 2008, the FSA published a summary of a review carried out by its internal audit division into its supervision of Northern Rock. In response to the review, the FSA's management introduced a supervisory enhancement programme dedicated to improving the execution of supervision.

The main features of the FSA's Supervisory Enhancement Programme were:(218)

- the recruitment of a new group of supervisory specialists to review regularly the supervision of all high-impact firms to ensure procedures were being rigorously adhered to;
- an increase in the numbers of supervisory staff engaged with high-impact firms, with a mandated minimum level of staffing for each firm;
- an expansion of the existing specialist prudential risk department of the FSA as well as the resources of the relevant sector teams;
- an upgrade of the current supervisory training and competency framework for FSA staff;
- an increase in the degree of FSA senior management involvement in direct supervision and contact with high-impact firms;
- greater focus on liquidity, particularly in the supervision of high-impact retail firms; and
- a raised emphasis on assessing the competence of firms' senior management.

Other changes introduced by the Supervisory Enhancement Programme included:

- a maximum two year regulatory period for full ARROW assessments of large groups;
- minimum requirements for the holding of C&C meetings; and
- a requirement for the supervision team to meet with the external auditors of large groups.

(218) See the FSA Press Release dated 26 March 2008 which set out details of the Supervisory Enhancement Programme: www.fsa.gov.uk/pages/Library/Communication/PR/2008/028.shtml

1123. The FSA Board did not play any operational role in decisions relating to the supervision of specific firms, and while it did receive briefing on current issues from executive management and was therefore in a position to ask questions and challenge assumptions, no prudential issues were raised in relation to HBOS in the pre-crisis period. ExCo also gave little time in the pre-crisis period to considering individual firm issues. Equally, FSA senior management responsible for HBOS did not adopt a proactive approach to their engagement with firms.(219) They prioritised their time with firms where there was crystallised risk rather than with the highest potential impact firms, such as HBOS. In particular, Mr Briault had very little involvement with the executives of HBOS and did not meet the HBOS Board during the Review Period.(220) The former Chief Executive of the FSA, Mr John Tiner, said in interview that his '*absolute expectation*' was that a Managing Director would also '*have relationships and a profile with the senior people and the Chairman and the board members of the individual firms. And that when there are key points to be communicated, that they should be in the room*'. However, Mr Briault appears to have been unaware of this expectation. Further, both Mr Briault and Mr David Strachan (the Director of MRGD) noted that Mr Tiner's expectation did not accord with either the framework for the supervision of high impact firms at the time or what happened in practice. The extent of senior management engagement with HBOS is considered further in Section 4.3.7, '*Involvement of FSA senior management in the supervision of HBOS in the pre-crisis period*'.

1124. The existence of sector teams, including one for banking, which were intended to identify cross-sectoral issues and trends which might not be apparent at a firm-specific level, also had implications for the way in which supervision was conducted. As described in *The Northern Rock Report,* the sector team concept, as actually implemented, did not result in effective flows of information and insight between the sector teams and the supervision teams. There was also insufficient focus on emerging risks, trend analysis and peer group comparisons.(221)

1125. FSA executive management articulated some high-level supervisory priorities during the Review Period, specifically the implementation of Basel II, which was an EU directive requirement, and the FSA's TCF initiative. As set out in *The RBS Report*, both had a major impact on supervisory resource at a time when prudential risks faced by firms were increasing.

1126. The process of assessing and validating Basel II models absorbed a very significant proportion of the FSA's specialist prudential risk resource during 2006 and 2007. In the long run, some benefits might have resulted from this new bank capital adequacy regime, which required more detailed assessment of asset-specific risks. However, considerable work was still required by HBOS in 2008 and many planned model changes were not approved prior to its failure. As a result, the devotion of significant FSA resources to Basel II implementation did not make a significant contribution to making HBOS, or any other major bank, more robust in the face of the financial crisis. The implementation of Basel II is considered in more detail in Section 4.6.3, '*Basel II implementation*'.

1127. The other priority was the FSA's TCF initiative, which was launched in late 2003 in response to a number of significant conduct failures, including personal pensions, mortgage endowments and split capital investment trusts. By 31 December 2008, firms were required to demonstrate to the FSA that they were consistently treating their customers fairly. TCF was an important FSA priority and firms were required to demonstrate via extensive internal documentation and through actual examples that they had processes and structures in place to ensure that the approach adopted at each stage of the product lifecycle placed appropriate focus on fair treatment. Reviewing the material and undertaking on-site visits to assess compliance with the

(219) FSA 'senior management' refers to Head of Department level up to Managing Director.
(220) Mr Briault's written statement to the PCBS. Files suggest that a meeting with HBOS's CEO was planned in summer 2007, billed as 'informal catch up chats to discuss key issues of the moment', but we have found no note of it.
(221) The weaknesses in this area were identified and discussed within The Northern Rock Report at Chapter D5, page 97.

principle in turn absorbed significant work by supervision and by conduct of business specialists. This initiative took up a lot of limited supervisory resource and management attention.

1128. In summary, FSA executive management, led by the Chief Executive Mr Tiner, designed (or failed to redesign) a deficient approach to supervision. Further, the oversight of the executive by the FSA Board, led by the Chairman Sir Callum McCarthy[222], was insufficient. The roles and responsibilities of the FSA Chairman and Chief Executive are described in Box 4.3. As the Managing Director of Retail Markets and a member of the FSA Board and ExCo from June 2004 until April 2008, Mr Briault was responsible for the strategy and performance of the business unit that supervised HBOS for the majority of the Review Period.

4.2.4 The roles of the FSA Board and ExCo

1129. The FSA was governed by a Board appointed by HM Treasury. The FSA Board broadly mirrored a corporate board governance model and was responsible for approving the FSA's strategy and the annual operating plan and budget. In addition to the requirements of the Companies Act and Combined Code on Corporate Governance, FSMA required the Board to discharge the FSA's legislative functions. These functions included making rules, issuing codes on approved persons and market abuse, and issuing statements of policy. The Board was also required to report annually to HM Treasury on the discharge of the FSA's functions and the extent to which its regulatory objectives had been met.

1130. Sir Callum was non-executive Chairman of the FSA Board from September 2003 until 19 September 2008, when he was succeeded by Lord Adair Turner of Ecchinswell. The Board's committee structure, which included a Risk Committee, an Audit Committee and a Remuneration Committee, remained unchanged during the Review Period.

1131. The FSA had two chief executives during the Review Period. Mr Tiner was CEO from September 2003 until 19 July 2007, at which point he was succeeded by Sir Hector Sants.[223]

Box 4.3: Roles and responsibilities of the FSA Chairman and Chief Executive

Role of the FSA Chairman
The Chairman's key responsibilities, as endorsed by the FSA Board, were to:

- establish and develop an effective Board;
- lead the Board as a team;
- plan and manage the Board's business;
- establish priorities for the FSA;
- maintain and develop a productive relationship with the FSA Chief Executive, for whose recruitment he was responsible;
- with the Chief Executive, lead the communication of FSA policies with a wide range of constituencies;
- represent the FSA at particular national and international financial institutions;

(222) Callum McCarthy became Sir Callum McCarthy in June 2005 and is referred to throughout the Report as Sir Callum.
(223) Hector Sants became Sir Hector Sants in December 2012 and is referred to throughout the Report as Sir Hector.

- establish and maintain high level contacts with the most important financial institutions worldwide;
- act as an accountability focus for the FSA; and
- represent the FSA in the most senior meetings of the Tripartite Standing Committee.

The Chairman could discharge his responsibilities by ensuring:

- the effectiveness of the Board in relation to: the balance of Board appointments (taking into account Treasury's responsibility for these appointments); the responsibilities, chairmanship and effectiveness of Board committees; the agenda for Board meetings; the relationship between executive and non-executive Board members; and the provision of appropriate, quality and timely information for directors;
- that the FSA's strategy was formulated clearly and was well understood internally and externally;
- that he provided a source of counsel and challenge to the Chief Executive on how the FSA was run. This included feedback to the Chief Executive on senior management performance, development and succession, and on organisational structure;
- regular evaluation of the performance of the Board, its committees and individual directors; and
- that he was properly briefed on FSA business to enable him to discharge his duties as Chairman, and to represent the FSA publicly. The Chairman had an unlimited right to consult any FSA employee, require information on any aspect of FSA business, and attend any executive meeting within the FSA.

Role of the FSA Chief Executive

The Chief Executive was responsible for implementing the strategy agreed by the Board, in whose formulation he will have played a major part. He had executive responsibility for the FSA's business under authority delegated to him by the FSA Board. Key responsibilities of the Chief Executive included:

- reporting regularly to the Board with appropriate, timely and quality information so the Board could discharge its responsibilities effectively;
- informing and consulting the Chairman on all matters of significance to the Board so that the Chairman and Board could properly discharge their responsibilities;
- developing and delivering the strategic objectives agreed with the Board;
- recommending to the Board significant operational changes and major capital expenditures where these went beyond his delegated authority;
- assigning responsibilities clearly to senior management and overseeing the establishment of effective risk management and control systems;
- recruiting, developing and retaining talented people to work at the FSA and, in particular, establishing a strong management team which was fairly and fully evaluated;
- communicating throughout the FSA the strategic objectives and the values of the FSA agreed with the Board, and ensuring that these were achieved in practice;
- sharing with the Chairman and other members of the FSA's senior management team the responsibility for communicating the FSA's messages externally; and
- representing the FSA at selected international financial institutions.

1132. Full membership of the FSA Board and ExCo during the Review Period is set out in Appendix 9.

The role of the FSA Board

1133. *The RBS Report* examined the role of the FSA Board in relation to the supervision of high impact banks. The findings of the HBOS Review are consistent with the conclusions set out in *The RBS Report* in that:

- The FSA Board did not play any operational role in decisions relating to the supervision of specific firms. The Board did though receive briefings on current issues, including major firm-specific issues, from executive management and so was in a position to ask questions and challenge assumptions. However, no prudential issues were raised in relation to HBOS in the pre-crisis period in board reports from either the Chief Executive, Mr Tiner, or the Managing Director for Retail Markets, Mr Briault.

- Reflecting the FSA's broad set of responsibilities, much of the FSA Board's time was devoted to considering a range of major legacy and conduct issues, such as Equitable Life, mortgage endowment mis-selling, the Retail Distribution Review and TCF.

- The FSA Board did not contribute in any substantive way to decisions on prudential standards, such as those relating to capital and liquidity. While it was required at times formally to approve the transposition of such standards into the FSA rulebook, capital standards were, and still are, developed at a global level via the Basel Committee and EU processes. In relation to quantitative liquidity standards, there were no global or European standards during the Review Period.

- Neither the FSA Board, nor its Risk Committee (which was responsible for oversight of risks to the FSA's statutory objectives), had been defined as responsible for an assessment of evolving macro-financial risks, in the way that the FPC now has responsibility.

1134. *The RBS Report* also noted that, until the summer of 2007, FSA Board agendas reflected the judgement that bank prudential issues were, at that time, a low priority, since market conditions were benign.(224) To illustrate this, minutes of FSA Board meetings between January 2006 and July 2007 indicate that only one out of the 61 'major topics' discussed related in some way to prudential issues. Furthermore, only one out of 110 items reported to the FSA Board within Mr Tiner's Chief Executive report related to bank prudential issues either in general or in relation to specific banks. Of 229 items reported to the Board by the Managing Director of Retail Markets, Mr Briault, only five related in some way to prudential issues. Three of these related to European regulatory issues and two related to the proposed RBS and Barclays' bids for ABN AMRO.

1135. The Board's Risk Committee minutes from the pre-crisis period reveal a broadly similar pattern. There was a strong skew of attention towards conduct or internal FSA issues and only limited focus on the emerging risks which were developing:

- While there were occasional discussions of credit risks, these appear from the minutes to have been skewed towards household lending in the UK and to have focused as much on conduct issues (for example, aggressive marketing to consumers) as on any potential consequences for bank soundness and financial stability. In May 2006, the committee did however discuss the risk of '*failures caused by significant environmental events*'. While this discussion included a focus on '*firms taking excessive levels of credit risk*', the minutes reveal an under-estimation

(224) The FSA's 2007 Financial Risk Outlook, published on 30 January 2007, stated that the 'Central economic scenario is one of relatively benign economic conditions and financial stability, a view which is in line with consensus forecasts': http://www.fsa.gov.uk/static/pubs/plan/financial_risk_outlook_2007.pdf

of the scale of the risks. The committee noted the results of analysis by the Bank of England, which concluded that: *'even extreme stress tests did not cause financial instability; financial stability was maintained when the results of more implausible tests affected the profit & loss account, but did not reduce the capital of the company'.*

- Discussion of the developments which we now know were forward indicators of future problems was limited and did not result in a greatly heightened level of concern. For instance, there was no apparent discussion of the increasing reliance of UK and other banks on wholesale funds and the resulting funding and liquidity risks that this could create. While the first apparent discussion of developments in the US sub-prime market at the April 2007 meeting prompted the question *'was this a risk reappraisal situation'* and the observation that *'markets could suddenly change'*, it was also noted that *'the US authorities have been fairly optimistic'* and *'the US authorities were not expecting a knock-on effect on prime* [household] *and commercial mortgage markets'*.

1136. It was the responsibility of the FSA Board and its committees to decide what issues were brought to them by executive management. However, in practice FSA Board and Board Committee agendas were prepared by executive management and the Chairman, and discussions at FSA Board and Board Committee meetings focussed on the items that executive management chose to cover in their reports.

1137. The Review found no evidence of the FSA Board or Board Committees challenging executive management on the appropriateness of the FSA's pre-crisis approach to the prudential supervision of banks or to those aspects of bank prudential regulation (for example those relating to liquidity) which the FSA could itself have changed without global agreement.

1138. Prior to the early stages of the financial crisis in summer 2007, while the FSA Board was at times involved in debates about new approaches to the regulation and supervision of firms, these did not include any detailed review of the approach to bank prudential regulation and supervision. The Board:

- gave attention to the challenges of supervising small firms which resulted in the FSA's strategy on Small Firm Supervision issued in 2005; and

- was involved in considering the FSA's supervisory philosophy at a high level (for example, the importance of a 'principles based' approach, the ARROW II initiative and related resourcing issues), but this did not involve detailed discussion of the appropriate design of the supervisory approach to bank prudential issues.

1139. In contrast, from summer 2007 onwards, the FSA Board was closely involved in the oversight of the FSA's response to the financial crisis. This included:

- detailed discussion in September 2007 about the response to the severe liquidity strains both in general and for specific banks. The Board expressed strong support for a proposal that the FSA Chairman, Sir Callum, should convey to the other Tripartite authorities the FSA's belief that solutions would have to involve liquidity support across the UK banking system;

- extensive involvement in satisfying itself with the programme of supervisory reforms that the FSA introduced in response to the financial crisis; and

- discussion and approval of the FSA's strategy for major UK banks in April 2008.

1140. The focus of the Board's Risk Committee also changed from summer 2007. For instance, at the July 2007 risk meeting, while the pre-set formal agenda was still dominated by internal and conduct issues (payment protection insurance (PPI), financial crime, information security standards, consumer driven frauds and anti-money laundering), the committee also focused on risks in sub-prime mortgages and hedge funds, and those arising from implicit bank liabilities or guarantees to support sponsored funds. At the October 2007 meeting, the committee noted that ExCo had fully revised the priority areas of risk in light of the market turbulence. Key risks discussed included liquidity, credit derivatives, valuations and confidence in the system. The minutes also recorded that the *'FSA had identified vulnerable firms'* which were being encouraged *'to raise cash and obtain medium to long-term funding, so as to avoid future problems'* (see Section 4.8, *'Contingency planning'* for further details). Supervisors were also *'encouraging firms to consider liquidity and the sustainability of business models'*. In September 2008, the *'Risk Committee encouraged the FSA to consider whether it would be appropriate to consult on higher capital requirements in due course',* beyond a 5% Core Tier 1 capital target set in April 2008.

Box 4.4: Mr Crosby's role on the FSA Board

For a significant portion of the Review Period, Mr James Crosby[225] was both HBOS Chief Executive and a member of the FSA Board. This box deals with the question of the potential for conflicts of interest or for undue influence on supervision as a result of Mr Crosby concurrently holding these positions.

Background
Mr Crosby became Chief Executive of HBOS in 2001 following the merger of Halifax with the Bank of Scotland (BoS). He continued to be employed by HBOS in the role of Chief Executive until he was succeeded in this position by Mr Andy Hornby in mid-2006.

Mr Crosby was appointed to the FSA Board in December 2003 and took up this appointment in January 2004.[226] He was a member of the FSA's Audit Committee, serving as its Chairman from July 2005 to September 2007. He assumed the role of Deputy Chairman and Chairman of the FSA Committee of Non-Executive Directors on 11 December 2007.

Mr Crosby announced his resignation from the FSA Board on 11 February 2009 following allegations of inappropriate changes made to the Group Regulatory Risk (GRR) function at HBOS during 2004. The claims made by Mr Paul Moore, former Head of GRR, which are considered in more detail in Section 4.7.4 (Box 4.10), included the allegation that Mr Crosby had not complied with HBOS's HR policies in making Mr Moore redundant and in appointing Ms Jo Dawson as Group Risk Director. Mr Crosby's public statement of resignation from the FSA Board refuted the allegations but stated that *'the right course of action for the FSA is for me to resign from the FSA Board which I do with immediate effect'*.

As set out in the statement issued by the FSA on 11 February 2009 following Mr Crosby's resignation from the FSA Board, the *'specific allegations made by Paul Moore in December 2004 regarding the regulatory risk function at HBOS were fully investigated by KPMG and the FSA, which concluded that the changes made by HBOS were appropriate… It should also be noted that the FSA's concerns about HBOS' risk management framework considerably pre-dated the allegations by Mr Moore'*.

Although the HBOS supervision team escalated the allegations to FSA senior management in December 2004, including the claim of unfair dismissal, the Review found no evidence that the Chairman of the FSA at the time, Sir Callum, was made aware of the specific allegations against Mr Crosby.

Potential impact and influence on supervision
The Review found no evidence that Mr Crosby exercised any undue influence as a member of the FSA Board or its committees on the decisions of the FSA in relation to the supervision of HBOS. As noted in the previous section, the FSA Board did not play an operational role in decisions relating to the supervision of individual firms, including HBOS, and its role had not been defined as such.

(225) James Crosby became Sir James Crosby in June 2006 but relinquished this title in June 2013.
(226) Members of the FSA Board were appointed by HM Treasury. Press release from HM Treasury on the appointment of Mr Crosby: http://webarchive.nationalarchives.gov.uk/20100407022214/http:/hm-treasury.gov.uk/press_135_03.htm

There was fairly regular and open dialogue between the supervision team manager and Mr Crosby in his capacity as HBOS Chief Executive. Although supervision team managers primarily acted as the main point of contact with firms, chief executives and chairmen of large firms typically communicated directly with FSA senior management, albeit on an infrequent and ad hoc basis. Mr Crosby, however, tended to contact the manager of the supervision team directly to discuss issues, which contributed to the firm's perceived 'open and co-operative' relationship with the FSA (see Section 4.3.8, *'Supervisory relationship with HBOS'*). Clearly this is a subjective area, but Mr Crosby's presence on the FSA Board may have been a factor in his open dialogue with the supervision team. Furthermore, it is possible that Mr Crosby's presence on the FSA Board could have resulted in the FSA treating HBOS more leniently, although the Review found no evidence of this.

As set out in Section 4.6.3, *'Basel II implementation'*, Lord Dennis Stevenson of Coddenham wrote to Sir Callum in June 2007 to protest about the FSA's Basel II 'minded to grant' decision (in effect a refusal by the FSA until further work had been completed) in respect of the firm's application to use the internal-ratings based approach. Following an internal review, the FSA concluded that due process had been followed in reaching this decision. The firm subsequently undertook further work to deal with the FSA's concerns and approval with conditions was granted in September 2007. Mr Crosby had left HBOS by this time but remained a member of the FSA Board. However, no evidence was found that Mr Crosby was either involved in or aware of this decision-making process within the FSA.

The role of the FSA's ExCo

1141. As the FSA's main executive strategic decision-making committee, ExCo was chaired by the Chief Executive and members included the Managing Directors, General Counsel and Directors of the Enforcement, Human Resources and Finance, Strategy and Risk Divisions. Formal ExCo meetings took place monthly, and members of ExCo also met informally on a weekly basis in what was known as ExCo 'morning tea' or 'prayers'. Members of the FSA's ExCo during the Review Period are set out in Appendix 9.

1142. ExCo had a number of sub-committees, including: the Regulatory Policy Committee (RPC) which met fortnightly and was responsible for determining policy on behalf of the FSA (ahead of the FSA Board giving approval for matters reserved for the Board) and for the oversight of policy work within the organisation; and the Firms and Markets Committee (FMC) which met weekly and facilitated information sharing on major regulatory or firm specific issues between senior management. There was substantial overlap in membership of ExCo, the RPC and the FMC, although alternates often attended the FMC in place of members.

1143. ExCo minutes did not provide a detailed account of all contributions, but were focused on recording the main items that were discussed and conclusions reached. As a result, it is likely that some points made by ExCo members were not recorded in the minutes.

1144. Analysis of FSA records and interviews with former ExCo members revealed that a significant proportion of ExCo's time was focused on operational and business planning issues during the Review Period. ExCo approved the FSA's operating budget and overall headcount. However, prior to summer 2007, while ExCo did have high-level discussions about resourcing and priorities, ExCo neither had in-depth discussions, nor received detailed management information, about specific aspects of the supervisory operating model, such as the supervisory resource per firm or the balance of work between conduct and prudential issues.

1145. In his capacity as a former ExCo member, Sir Hector commented in interview that *'the committee was dysfunctional in 2006'*. One area he referred to specifically was the fact that major issues from the Retail business unit were not brought to ExCo. A report summarising the findings of an internal FSA review of the effectiveness of ExCo carried out in 2007, noted that the committee's agenda needed to be '*more strictly managed to ensure that ExCo saw items it wanted to discuss, not simply those served it by the business*' and that '*ExCo members can give the impression of defending their own patch rather than focusing on the organisation collectively.*' However, the report concluded that ExCo was '*generally effective*' and Mr Briault informed the Review that he could not recall ExCo being described as '*dysfunctional*' at the time.

1146. No evidence was found that ExCo discussed either the supervisory consequences of headcount reductions after the FSA embarked on a strategy of 'fewer, better staff' in late 2006 or of the amount of resource absorbed by delivering Basel II and TCF. While ExCo had some general discussions about the FSA's philosophy on principles-based versus rules-based regulation, it did not consider the extent to which supervisors were placing reliance on firms' senior management and consequently ExCo did not set a risk appetite around this practice.

1147. Although ExCo had a largely operational focus, sector-wide and risk issues were discussed at meetings, as was the new ARROW II process. Each sector team reported to ExCo annually and the Risk Division presented a 'Risk Dashboard' to ExCo on a quarterly basis. Agendas show that conduct issues (including matters of crystallised risk) were considered more commonly than prudential issues. ExCo did discuss some prudential issues prior to summer 2007:

- ExCo received two presentations on the banking sector during this period. On 19 July 2005, ExCo discussed the impact of Basel II on capital requirements and the minutes noted that the *'FSA should consider increased capital requirements for the 'super league' of banks'*. Minutes of the 15 March 2007 ExCo discussion on the banking sector noted that the *'sector was prudentially sound and there was no need for the FSA to be unduly concerned, although the subprime market was one issue'*. The minutes also recorded that *'banks were well capitalised'* but were sustaining a difficult balance of capital controls and business risk and *'the challenges could increase as the economic environment became less benign'*.

- On 20 September 2006, ExCo was given a presentation on the implementation of Pillar 2 of the Basel II framework. The minutes noted that ExCo was informed that, in 2007, *'Pillar 2 was likely to take 10-15% of supervisors' time via the Supervisory Review and Evaluation Process (SREP)'*. However, there is no record that a more detailed discussion took place on the wider impact this would have on supervisory resource. Pillar 2 was again discussed by ExCo on 11 January 2007. The minutes noted that difficulties had been encountered with regards to formulating messages on risk appetite, as there was a range of views within the FSA.

- On 17 May 2007, ExCo discussed the possibility of a credit crisis. The minutes recorded that ExCo agreed that the FSA *'should contribute to international debate on the issues'* and *'could explore with firms' senior management what their expectations of FSA would be in the event of a credit crisis'*.

1148. However, prior to the financial crisis, ExCo provided limited strategic prudential direction to supervisors of individual firms. While the RPC regularly discussed prudential policy matters, such as the implementation of the Capital Requirements Directive/Basel II and liquidity risk management, its role was to consider the development or interpretation of policy for general application. It was not concerned with firm specific issues.

1149. Individual firms were rarely discussed at ExCo meetings prior to the financial crisis, other than in reviewing the FSA Watchlist (see Section 4.3, *'Prudential supervision of HBOS'*). Indeed, there was only one mention of HBOS in ExCo minutes prior to August 2007. The minutes of the 2 July 2007 ExCo meeting noted under 'any other business' that *'HBOS was unhappy with their "Minded to Grant" status'* in respect of its internal ratings based (IRB) waiver application.[227] The

(227) 'Minded to grant' was in effect a refusal by the FSA to grant the IRB waiver until further work had been completed.

executive management team did receive information about individual firms through their membership of the FMC. However, the FMC was primarily a reactive information sharing (rather than a strategic decision making) forum, and issues that were escalated to it typically involved crystallised risk.

1150. The executive management team had very little proactive engagement with Retail firms and their supervision teams, unless there was crystallised risk. This meant that ExCo and the Board were unable effectively to track progress by front-line supervision. This limited engagement also meant that executive management were unlikely to spot deficiencies in the supervision of individual firms or the overall build up in prudential risk.

1151. In contrast, from summer 2007, the focus of ExCo started to change in response to the financial crisis, with prudential and supervisory resourcing issues increasingly discussed. For instance, at its meeting on 13 August 2007, ExCo discussed the current market conditions and the minutes noted that a daily market conditions meeting had been convened to look at a number of liquidity issues, including at firms such as HBOS.

1152. On 18 December 2007, ExCo discussed whether there was a need to prioritise statutory objectives, given the growing and conflicting demands on supervision team managers, and whether the primary interest of the FSA should be prudential. Minutes noted an action for further bilateral discussions to take place with the Chief Executive about the balance of priorities for supervisors. Executive management formed the view that detailed processes needed to be reformed, which would take time. A top-down contingency planning process was therefore established to address immediate prudential priorities. This overlaid the existing supervisory model and on-going day-to-day supervision of firms. ExCo subsequently had extensive discussions in early 2008 about the lessons learned from the failure of Northern Rock and agreed on 14 February 2008 to create the Supervisory Enhancement Programme (see Box 4.2 above).

1153. From early 2008, ExCo became increasingly involved in discussing firm-specific issues and was heavily involved in contingency planning in the context of the financial dislocation and subsequent crisis. For instance, analysis of ExCo minutes for the period 1 January 2008 to 1 October 2008 revealed that HBOS was referenced in the minutes of 26 separate meetings in relation to prudential issues, 18 of which were direct discussions about contingency planning for HBOS. The contingency planning work undertaken by the FSA in relation to HBOS during the financial crisis period is considered in more detail in Section 4.8.

4.3 Prudential supervision of HBOS

4.3.1 Introduction

1154. This section considers how HBOS was supervised by the front-line supervision team(228) and how key aspects of the FSA's overall approach to supervision, described in the previous section, were applied to HBOS. It covers:

- the timeline of HBOS ARROW assessments (Section 4.3.2);
- the supervisory priorities for HBOS (Section 4.3.3);
- the evolution of the FSA's risk assessment of HBOS (Section 4.3.4);
- the C&C supervision of HBOS (Section 4.3.5);
- supervision team resources and turnover (Section 4.3.6);
- the involvement of FSA senior management in the supervision of HBOS (Section 4.3.7); and
- the supervisory relationship with HBOS (Section 4.3.8).

1155. Although the Review Period starts on 1 January 2005, certain events from 2004 are summarised in this section in order to provide context.

1156. The broad environment within which front-line supervision operated in the FSA prior to the onset of the financial crisis is set out in Section 4.2 above. The FSA Board had no engagement in supervision and senior management's firm-specific engagement was generally limited to dealing with crystallised risks. The FSA's strategy focused on conduct issues, particularly the TCF initiative, and the implementation of Basel II on the prudential side.

1157. Supervisors were generally expected to rely on firms' senior management and control functions both as sources of information about the business and its risks and to deliver the outcomes that the FSA wanted. They were not expected to analyse or challenge firms' strategies or business models, or to undertake independent financial analysis of regulatory returns or other quantitative information. Risk identification and assessment generally relied on information from the firm, either by provision of internal management information or through periodic meetings.

1158. Front-line prudential supervisors had very limited access to expert support: prudential risk specialist resources were almost entirely devoted to Basel II implementation; flows of information, analysis and insights between supervisors and the sector teams were ineffective; and the prevailing wisdom was that Skilled Persons Reports by external parties should not generally be used as a tool of 'business as usual' supervision (see Box 4.1: *'FSA use of Skilled Persons Reports'*).

(228) References to the HBOS 'supervision team' throughout this report are to the FSA team, led by a relationship manager, responsible for the supervision of HBOS.

1159. The supervision team, led by a manager, was the main point of contact between the FSA and the firm. It dealt with both conduct and prudential issues and its tasks ranged from the day-to-day (such as executing the programme of C&C meetings and dealing with queries and requests for guidance from the firm), through to ad hoc issues, thematic initiatives and major 'set pieces' such as the ARROW and SREP.

1160. The supervision team suffered from a lack of continuity, experience and senior FSA management engagement. A more experienced, stable and better supported supervision team might have been more sceptical about the effectiveness of the relationship with HBOS senior management given its knowledge of issues at the firm at the time. Had it been more sceptical, it might have taken a number of actions to address weaknesses in the pre-crisis period. A more probing, sceptical and interventionist stance in the pre-crisis period could have delivered different outcomes but this would have required a significant increase in the resources, experience and seniority of the team, together with a different strategic approach to supervision and the active support of FSA executive management and the Board.

4.3.2 Timeline of HBOS ARROW assessments

1161. During the Review Period, the regulatory period for full ARROW assessments of large groups was typically two to three years. However, only one full ARROW assessment of HBOS was completed during the Review Period.

1162. As set out in Table 4.1, the April 2008 ARROW letter was sent three years and four months after the previous full ARROW assessment in December 2004, immediately prior to the start of the Review Period. Although an interim ARROW was completed in June 2006, it is clear that there was considerable slippage in the regulatory period for HBOS.

Table 4.1: Timeline of HBOS ARROW Assessments

Event	2004 (Interim)	2004 (Full)	2006 (Interim)	2008 (Full)
Planning panel[a]	N/A	N/A	N/A	8 November 2007
Visits	N/A	2004 Q4	N/A	2007 Q4
Final validation panel	N/A	8 December 2004	N/A	26 February 2008
ARROW letter issued	13 January 2004	21 December 2004	29 June 2006	22 April 2008

(a) Planning Panels were introduced in 2006 under the ARROW II methodology.

1163. The December 2004 ARROW letter informed HBOS that the next full ARROW review was due to take place in December 2006. The firm was also due to be subject to an interim ARROW review, half way through the regulatory period, at the end of 2005. However, approval to postpone this interim review by six months was given by the supervision Head of Department in November 2005 on the basis of constraints on FSA resource (see Section 4.3.6, '*Supervision team resources and turnover*'). The interim ARROW letter was sent on 29 June 2006.

1164. Having just completed an interim review, it would have been unusual for the supervision team to complete a full assessment only six months later, as previously intended. The June 2006 ARROW letter informed HBOS that '*… your next full assessment will be carried out under the Arrow II framework during 2H 2007*'.

1165. There were also delays in finalising the December 2007 ARROW review. While discovery work commenced in November 2007, the ARROW validation panel took place on 28 February 2008. The FSA delayed sending the ARROW letter until 22 April 2008 amid the uncertainty surrounding the collapse in HBOS's share price during March 2008 (see Section 4.8, '*Contingency planning*' for further details).

1166. The cumulative effect of the slippage in the regulatory period for HBOS was that supervisory priorities were not formally refreshed in the middle of the Review Period as they would have been had a full ARROW rather than an interim ARROW taken place in 2006. This is because interim ARROW assessments were desk-based reviews, so findings were not based on any detailed discovery work.

4.3.3 Supervisory priorities for HBOS

1167. FSA executive management did not set an explicit requirement for supervision teams to document formally a supervisory strategy for either the prudential or the conduct supervision of firms. Consequently, one did not exist for HBOS for any point during the Review Period.

1168. Nonetheless, the high-level supervisory priorities for HBOS have been reconstructed by analysing supervisory records, including ARROW assessment letters and RMP actions, which were the main supervisory tools for articulating FSA priorities to the firm's Board. The evolving supervisory priorities for HBOS are summarised below.

Context prior to the Review Period – 2004

1169. Prior to the Review Period, in early 2004, the main focus of the supervision team was on the adequacy of HBOS's systems and controls, particularly given, as noted in the January 2004 interim ARROW letter, that HBOS was continuing to '*target and deliver ambitious growth across all areas of the business, putting the Group out of line with its peers*'.

1170. In January 2004, the supervision team emphasised to the firm the need for Group Risk functions to be sufficiently embedded and for appropriate controls to be in place to monitor and control the risk profile of the significant growth in Corporate's commercial property portfolio. Following a Retail risk assessment at the end of 2003, the control framework within that division was also an area of concern. A further supervisory priority at that time was to ensure that HBOS Group had a detailed funding plan to ensure a stable and diversified supply of funding and that a contingency plan was in place in the event that the firm experienced difficulties with funding. These priorities were set out in the January 2004 interim ARROW letter and were a reasonable and early articulation of the risks that would eventually crystallise and cause HBOS to fail.

1171. In response to these weaknesses found during the ARROW assessment, action was taken at that time to increase HBOS's Individual Capital Ratio (ICR) from 9% to 9.5%. This was described to the firm as a '*significant action*' for the FSA to take. A Skilled Persons Report, which was fairly rare by the standards of the time, was also commissioned to review the effectiveness of HBOS's risk management framework. The use of both these supervisory tools would have delivered strong messages to the firm about the adequacy of its control environment.

December 2004 – December 2005

1172. A full ARROW assessment was completed in December 2004. This set out the main supervisory priorities coming into the Review Period in January 2005.

1173. As set out in more detail in Section 4.7, '*Supervisory approach to management, governance, culture and control functions*', the Skilled Persons review, which was carried out by PwC following the January 2004 ARROW assessment, concluded that HBOS's risk management systems were generally working well. While PwC highlighted a number of areas that required improvement, an action plan was established by Group Risk to take these recommendations forward. Following PwC's report, the supervision team was content at the time of the December 2004 ARROW that the Group's risk management framework was '*fit for purpose*'. Together with the progress made by HBOS in remediating some of the control risks, the supervision team took sufficient comfort to remove HBOS's capital add-on in December 2004. As a result, concerns about HBOS's risk management framework moved lower down on the supervision team's priority list.

1174. The December 2004 ARROW letter, which was signed off by FSA senior management at the ARROW validation panel, made it clear that HBOS still needed to make further progress in relation to risk management. The supervision team requested that Group Risk and Group Internal Audit undertake various divisional reviews and emphasised to the firm that: *'the Group Risk functions still need to enhance their ability to influence the business'*. A detailed list of divisional RMPs was also set, which included actions for Corporate relating to atypical credit sanctioning, provisioning and stress testing in the prudential space.

1175. The supervision team documented preparation for Basel II as a priority issue for the first time in the December 2004 ARROW letter. It was viewed as the *'biggest Group-wide issue facing HBOS'* coming into the Review Period. It involved numerous visits by FSA specialists and monthly updates with the Basel programme directors throughout the Review Period. Similarly, the team first identified TCF as a priority issue in the December 2004 ARROW letter. Both Basel II and TCF were FSA priorities and, as such, remained significant, resource intensive projects for the HBOS supervision team for the majority of the Review Period.

1176. The sales culture in Retail and specifically its handling of mortgage endowments had also emerged as a new priority issue in late 2004 and there was an ongoing focus on controls in the Insurance Division in the early part of the Review Period.

1177. It is notable, however, that funding was not mentioned in the December 2004 ARROW letter so was no longer seen as a priority issue. This followed progress made in 2004 by HBOS to diversify its sources of funding and extend the tenor of its wholesale funding (see Section 4.5.4, *'Supervision of HBOS's liquidity and Treasury assets in the pre-crisis period'* for more detail).

January 2006 – August 2007

1178. Throughout 2006 and 2007, there remained a strong emphasis on both TCF and Basel II implementation. The priority attached to these projects was articulated to the firm in the June 2006 interim ARROW letter:

- Basel II implementation *'in our view remains a high risk. As you are aware significant progress needs to be made on credit risk modelling and demonstration of compliance with the use test… The Basel II programme will be a key focus of our work on the Group in 2006'*; and
- *'TCF is a high priority for FSA and will need to remain a key regulatory focus for the Group'*.

1179. During this period, the supervision team continued to have concerns about HBOS's divisional systems and controls. In particular, controls within the Insurance Division had moved high up on the priority list. The control framework in the life companies was highlighted as one of the *'two biggest risks to the Group'*, alongside Basel II, in the June 2006 ARROW letter.

1180. A further area of concern for the supervision team remained *'the aggressive overseas growth strategy'* in International and the adequacy of its controls. However, while these concerns were regularly discussed with HBOS senior management during this period, International received a considerably lower degree of supervisory attention than other divisions (see Section 4.4.4, *'Supervision of asset quality in International'* for more detail).

1181. By mid-2006, the supervision team took the view that Corporate had *'made good progress'* in developing its credit grading systems and enhancing its credit decision making process. HBOS had also engaged KPMG to carry out a review of Corporate's collective provisioning model in 2005, following a request made by the FSA. Reflecting this progress, together with a MRGD initiative to reduce the number of open RMP actions (see Section 4.3.8, '*Supervisory relationship with HBOS*'), no specific RMP actions were set on these issues at the June 2006 ARROW. Instead, they were followed up through close and continuous supervision and as part of the Basel model review work.

1182. Throughout 2006 and early 2007, supervision of the Retail Division remained a high priority for the team due to a number of high profile conduct issues, such as mortgage endowment complaints and PPI. There was also some impetus around business continuity planning throughout 2006, following the July 2005 London bombings.

September 2007 – October 2008

1183. Supervisory priorities were immediately influenced by the failure of Northern Rock and the focus on prudential issues grew considerably in the final year of the Review Period. Funding became a high priority from September 2007 and the supervision team commenced weekly and later daily monitoring of HBOS's liquidity position. FSA records from November 2007 indicate that the team viewed funding and liquidity as HBOS's *'most significant risk'*.

1184. The April 2008 ARROW letter, which was based on a risk assessment conducted in November and December 2007, set the primary focus as ensuring that HBOS took decisive steps to deal with the increased capital, funding and liquidity risks in its balance sheet. Credit risk was also seen as significant area of concern given *'the Group is one of the most exposed to the risks of a UK downturn'*. The supervision team communicated to the firm in the 2008 ARROW letter that it would *'heavily monitor credit risk and provisioning across all of HBOS, and key areas will be looked at in depth on a thematic basis during 2008'*.

1185. The focus on HBOS's balance sheet developed into contingency planning work for HBOS, in particular from March 2008, as markets continued to deteriorate. Contingency planning, which is considered in more detail in Section 4.8, remained the highest priority for the remainder of the Review Period.

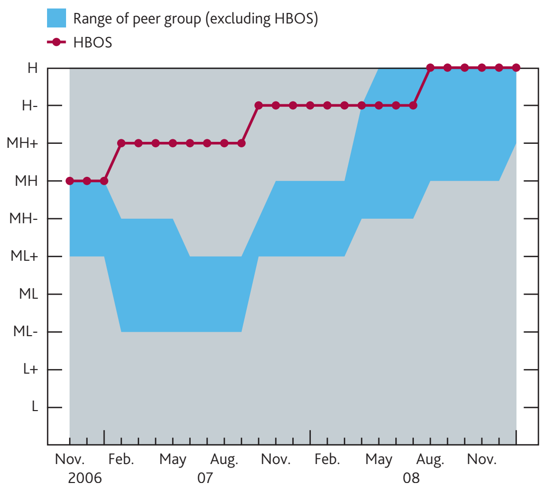
1186. However, routine supervision work also continued alongside the contingency planning work. As set out in the April 2008 ARROW letter, other outcomes that the supervision team was seeking to achieve in 2008 were that HBOS:

- enhanced its Corporate models as part of Basel II implementation;
- delivered the necessary TCF outcomes by the end-2008 FSA deadline;
- addressed weaknesses in its operating controls and IT systems; and
- made improvements to internal audit and corporate governance by being more proactive in identifying and implementing improvements.

1187. The supervision team's work in relation to asset quality, liquidity, capital and management, governance and culture is considered in more detail later in this Part.

4

Chart 4.1: HBOS total net probability against its peer group[(a)] range



(a) The peer group for this purpose comprises Abbey National, Barclays, HSBC, Lloyds TSB and RBS.

4.3.4 Evolution of the FSA's risk assessment of HBOS

ARROW probability scores

1188. An important part of the ARROW process was to benchmark a firm's risk profile against its peer group. Probability score data on the likelihood of events occurring were only available from late 2006 when the FSA introduced a new risk data management system (IRM). Judgements about probability scores were primarily taken at the supervision team level, although there may have been some input or challenge from senior management, for example during an ARROW validation panel.

1189. As can be seen from Chart 4.1, HBOS was scored as having a higher probability of risk crystallising than the peer group average throughout 2007. In March 2007, the higher than average score was driven by Medium High scores for HBOS's control functions, business risks and business controls. As set out in Section 4.7, '*Supervisory approach to management, governance, culture and control functions*', the control scores were skewed by areas with control weaknesses, such as HBOS Financial Services (within the Insurance Division), where there was crystallised risk. At that time, HBOS's capital and liquidity were scored neutrally as Medium Low.

1190. In October 2007, just after the failure of Northern Rock, the supervision team increased HBOS's total net probability score to High.[(229)] This was earlier than for its peer group as HBOS was seen to be more vulnerable to environmental risks due to its funding model. As noted previously, this prompted the supervision team to undertake close monitoring of HBOS's liquidity position, which developed into contingency planning work for the firm. In April 2008, the supervision team increased HBOS's probability score for credit risk from Medium High to High. IRM recorded the reason for this: '*The external environment has worsened and may lead to an increase in HBOS's credit risk. HBOS's large exposure (72% of total assets) to residential and commercial property increases the impact of any property downturn in the UK*'. HBOS's overall score was subsequently increased to the highest level in July 2008.

(229) H- or H are both regarded as 'high' scores when the overall position is reported.

FSA Watchlist

1191. The Watchlist was a tool within the FSA's risk framework to escalate risk issues in firms to FSA senior executives and to monitor subsequent progress on their resolution. ExCo reviewed the Watchlist monthly and the FSA Board looked at it on a quarterly basis. ExCo's role in relation to the Watchlist included approving additions and deletions proposed by supervisors, and requiring firms to be added or deleted on its own initiative. The Watchlist's summary page was also shared with the Bank of England. As such, the Watchlist was a further indicator of FSA supervisory concern about a firm. Placing a firm on the Watchlist did not necessarily signal a heightened concern about prudential soundness as firms could also be placed on the Watchlist because of important conduct or technical compliance issues.

1192. In the Review Period, HBOS was first added to the FSA Watchlist in October 2007. The issue description was: *'HBOS, as the largest mortgage lender and reliant on wholesale funding, is susceptible to the market wide tightening of liquidity. There is no evidence that the HBOS name is suffering, however their funding position remains vulnerable'.* No reference was made to credit risk.

1193. Alliance & Leicester (A&L) and Bradford & Bingley (B&B) were added to the list at the same time for similar reasons.

Use of risk dashboard material produced by the Banking Sector Team

1194. The FSA had a number of sector teams during the Review Period, such as asset management, banking, financial crime, insurance and financial stability. Part of the role of these teams was to produce a risk dashboard for their sector. The risk dashboard, which was included in quarterly Board and ExCo MI packs, articulated the context of potential risks and who could be affected.

1195. A March 2005 dashboard entry, for example, in respect of corporate credit risk stated that: *'financial fragility within several key corporate sectors would pose significant risks to the FSA. Specifically: banks could suffer losses on their loan portfolios (though given the generally strong capital position within the sector, this is likely to cause immediate prudential problems or loss of confidence only in extreme scenarios)'.* The March 2005 entry also recorded that: *'Commercial property remains a source of concern … the fastest growth continues to come from RBS and HBOS'.* The supervision team's concerns at this time about HBOS's commercial real estate (CRE) lending were followed up with the firm through C&C supervision (see Section 4.4.3, '*Supervision of asset quality in Corporate'* for more details) having previously been identified as a priority issue in the January 2004 ARROW letter.

4.3.5 Close and continuous supervision of HBOS

1196. In addition to the formal, periodic ARROW assessments that were required for all supervised firms, there was regular contact with high-impact firms, such as HBOS, through a scheduled programme of meetings. These meetings were collectively known as C&C supervision.

1197. For the majority of the Review Period, supervision teams within MRGD had discretion on the number and type of C&C meetings that took place. A supervision team would typically meet a firm's chief executive annually and heads of control functions more frequently, for example monthly or quarterly. Meetings with other members of the senior management team would depend on the structure of the firm. The purpose of the C&C meetings was to obtain updates on the firm's business plans, follow up on known regulatory issues and identify risks and issues that might require further investigation.

1198. FSA records indicate that in excess of 400 C&C meetings were held with HBOS during the Review Period, which is higher than the peer group average of 204 C&C meetings. This reflected HBOS's federal structure, which required the supervision team to meet with the separate divisions as well as the Group functions. The supervision team also complied with the requirements for the holding of C&C meetings introduced in March 2008, following the FSA's Supervisory Enhancement Programme. By this point, detailed contingency planning work was being undertaken for HBOS.

1199. While the number of meetings is not, on its own, a measure of the effectiveness of supervision, the level of engagement with each division provides an indication of how the supervision team prioritised its resource. The supervision team clearly prioritised its engagement with Group, typically meeting with the Group Risk Director once a month. Of the various divisions, Retail was treated as the highest priority, reflecting the relative size of its balance sheet compared to other divisions, together with the focus on a number of high profile conduct issues and the FSA's TCF initiative.

1200. It is notable that some inconsistencies were found in the quality of records of C&C meetings held between mid-2006 and early-2007, which made it difficult to track the degree of challenge provided by the supervision team during this period. It is also possible that some additional meetings took place which this Review has been unable to evidence.

1201. Beyond this formal schedule of C&C meetings, there were a significant number of other meetings between the FSA and HBOS.(230) This included ARROW meetings, visits by FSA specialists, Basel II model visits (for example 21 Basel II meetings with Corporate in 2006) and reactive or ad hoc engagement.

Liaison with external auditor

1202. A requirement for the supervision team to meet with the external auditors of large groups, such as HBOS, came into effect in mid-2008 when the FSA implemented its Supervisory Enhancement Programme. Prior to that, practice varied although it was usual for the supervisors of a large Group to meet the external auditors as part of a full ARROW assessment.

1203. The supervision team met KPMG, HBOS's external auditor, as part of the December 2004 and April 2008 ARROW reviews. The December 2004 ARROW meeting covered a range of issues, including the control environment. KPMG thought that *'HBOS had made progress during the year and that the overall control environment had improved'* but expressed concern about whether the volume of items on the agenda at Risk Committees *'could limit the amount of challenge that the NEDs were able to apply'*. The minutes of this meeting also recorded that KPMG had concerns about the growth of HBOS's overseas operations and that KPMG *'shared the Group's view that Commercial Property was not a particular threat to their financial health'*.

1204. The FSA's ARROW meeting with KPMG on 15 January 2008 focused on key economic and market risks faced by HBOS, including liquidity and credit risk. On Retail provisions, KPMG noted that HBOS was conservative on the secured provision and that KPMG was trying to '*wean them off*' this approach. On Corporate provisions, KPMG noted that the firm was slow in recognising specific provisions, with a tendency to be optimistic or say '*not enough information*'. On International, KPMG noted that the Irish property and Australian commercial businesses were the biggest risk areas, but that they were '*ok so far*'. Other issues covered included control functions, KPMG's management letter, governance and information technology (IT). In relation to IT, HBOS was *'not seen as an outlier by KPMG'* with KPMG viewing the firm as being *'in the pack in terms of resilience and controls'*.

(230) FSA files suggest approximately 380. This figure is based on meeting records seen by the Review. It excludes meetings with the Insurance and Investment Division, which is out of scope of this Review.

1205. Supervision teams could also meet the external auditors in relation to specific issues or transactions. In 2005, the supervision team met KPMG to discuss the accounting treatment of an imminent HBOS preference share issue and also as part of KPMG's non-audit review of allegations made by Mr Moore (see Section 4.7.4, Box 4.10). A further meeting took place in February 2007 to discuss a with-profits issue. Such meetings were, however, infrequent and records indicate that just one telephone call (relating to an insurance issue) took place with KPMG in 2006.

1206. The supervision team's final meeting with KPMG during the Review Period was on 1 September 2008. This was in effect the first meeting required by the FSA's new process following the implementation of the Supervisory Enhancement Programme. This meeting covered key financial reporting risks, provisions, Treasury, Group Internal Audit and Basel II. The supervision team also raised various concerns that they had about Corporate credit and the level challenge from Group. The FSA's record of this meeting noted that *'KPMG were broadly aligned with the FSA on key risk areas'* but that *'KPMG are probably behind the FSA in that they were less aware of the delay in re-ratings within Corporate'*. The supervision team also observed that: *'More work is needed on Treasury assets'*. At this meeting, KPMG indicated that they would be '*a lot tougher on Corporate provisions discussions this time round*' and that *'a gap would need to be closed for year-end 2008'*. KPMG also confirmed that they would conduct file reviews for the year end audit to test whether credits were migrating through to the higher grades quickly enough. The meeting also covered KPMG's views on governance from their attendance at HBOS's Audit and Risk Control Committees. The minutes recorded that: *'KPMG felt the HBOS governance structure was good, there was good NED challenge, a good tone and the framework was better than elsewhere'*. However, the minutes also noted that KPMG did have concerns about the culture and controls within Corporate.

4.3.6 Supervision team resources and turnover

1207. This sub-section assesses whether the level of supervisory resource for HBOS was adequate and whether it was in line with other large banks at certain points during the Review Period.

1208. HBOS was supervised as part of a wider team that was also responsible for two other groups. At the start of the Review Period, the wider team had responsibility for the supervision of A&L and from March 2007, following a divisional reorganisation, A&L was replaced by National Australia Group (NAG). Throughout the Review Period, the team was also responsible for St James's Place (SJP).

1209. Table 4.2 sets out how the resources on the HBOS supervision team, as well as on the wider team, changed over the Review Period. It also provides a comparison with the level of resource engaged on RBS. The figures in this table should be regarded as indicative as, in practice, the proportion of the team's resource working on HBOS would vary with workload. For example, all members of the wider team would have helped out on the HBOS ARROW review. In addition, some members of the HBOS team would have been involved in major pieces of work for other firms supervised by the wider team, for example when an ARROW review was undertaken or at key stages during Basel II implementation. Team members would also have contributed to FSA divisional initiatives, such as training.

Table 4.2: Supervision team resources(a)

	January 2005	May 2006	August 2007	June 2008
Wider team total(b)	7	7	10(c)	9
HBOS total	5.5	5.5	6	7
RBS total(d)	7	7.5	4.5	7

(a) Resources are estimates and expressed as full time equivalent. The figures include the manager and associates on the supervision team. For the purpose of these figures, it is assumed that the manager spent 80% of their total time on HBOS and 20% on wider team responsibilities.
(b) Team total includes individuals supervising all firms in the wider team portfolio: HBOS, A&L, NAG and SJP.
(c) There were two new graduates on the team at this point.
(d) RBS figures taken from *The RBS Report*. As set out in *The RBS Report*, the RBS and Barclays supervision teams were merged under one manager with effect from February 2007. The figures for August 2007 and June 2008 assume the resource on the team was split equally between the two firms.

1210. The level of resource engaged on HBOS ranged from the full time equivalent of 5.5 supervisors at the start of the Review Period (which was fewer than the RBS team at that time), to 7 supervisors in June 2008 (which was the same as RBS). In 2007, resourcing for HBOS was slightly higher than RBS following a merger of the RBS and Barclays supervision teams.

1211. Throughout the Review Period, the equivalent of approximately two members of the HBOS supervision team were responsible for the Insurance Division and HBOS joint ventures (Sainsbury's Bank and esure) which are outside the scope of this Review. The remaining resource on the team was responsible for prudential and conduct issues spanning HBOS Group, Corporate, Retail, International and Treasury.

1212. The supervision team acted as the main contact point between the FSA and the firm, and the focal point for coordinating the use of specialists from other areas of the FSA in order to achieve desired supervisory outcomes. Resource available to support the supervision team included: market/traded risk, credit and operational risk specialists; capital and liquidity policy specialists; actuaries to support insurance related work; specialists supporting the roll-out of particular FSA priorities, for example the TCF initiative and Basel II implementation; and sector specialists, for example, on financial crime. As noted previously, a significant proportion of the FSA's prudential specialist risk resource was absorbed by the Basel II implementation process in 2006 and 2007.

1213. Although consistent with the FSA's prevailing approach, the supervisory resource applied to HBOS was too low compared to what the Prudential Regulation Authority (PRA) and Financial Conduct Authority (FCA) would now consider to be appropriate. As a result, the supervision team, together with MRGD senior management, had to make decisions about how to prioritise the resource on HBOS. It is clear that Treasury and International received a considerably lower degree of supervisory attention than other divisions for much of the Review Period. Furthermore, responsibility for these divisions was, in general, allocated to relatively new or junior members of the team.

Turnover and experience on the HBOS supervision team

1214. For a number of reasons, including promotions and resignations, a certain amount of staff turnover is to be expected. However, the HBOS supervision team experienced a particularly high level of turnover during the Review Period. Combined with some deficiencies in record keeping, particularly in the middle of the Review Period, this created a lack of continuity such that, if an issue was identified more than once, it became more likely that the two events would not be connected together by the HBOS supervision team, making it harder to draw overall conclusions. The high turnover also made the team less effective while new team members were getting up to speed, and contributed to delays in ARROW reviews.

1215. HBOS was supervised by four different managers (including an acting manager) during the Review Period. While the same Head of Department was in place throughout, providing some level of consistency, the manager was seen as the main point of contact with the firm. The potential impact of this turnover should therefore not be underestimated.

1216. The first manager supervised HBOS from 2001 until resigning from the FSA in April 2006 and was considered by FSA senior management to be strong and experienced. The replacement was an internal appointment of an existing FSA supervision manager. Although it is difficult to assess the full impact of a change of manager at this point, it coincided with a number of other changes, both at HBOS and within the FSA. These changes included Mr Hornby taking over from Mr Crosby as HBOS Group Chief Executive, the introduction of a new process in the form of the FSA's ARROW II approach and MRGD's 'C&C challenge' initiative (see Section 4.3.8, '*Supervisory relationship with HBOS*'). This change of manager also took place a few months before the June 2006 interim ARROW was finalised. In late 2006, FSA senior management embarked on a strategy of 'fewer, better staff'. The primary impact for the supervision of large groups, such as HBOS, was that as part of this initiative a more senior grade was introduced for managers. This change was in recognition that the complexity of such firms needed skilled and experienced supervisory managers with more gravitas and impact managing the relationship with firms.

1217. The resulting restructure led to the manager of the HBOS team moving on from the role in April 2007. Pending the recruitment of a new manager, the team's lead associate(231) was appointed as acting manager for the period from May 2007 up to the end of August 2007. A new manager joined the team in September 2007, having been recruited from outside the FSA, and was a former corporate banker. During the period when there was an acting manager leading the team, the Head of Department became much more closely involved in the day-to-day supervision of HBOS.

1218. While there is evidence that reasonable handovers took place between the managers, it would have taken time for new managers to get up to speed with all the issues.

1219. The turnover of team members was also at the higher end of the spectrum for large groups during the Review Period. To quantify this, all but one of the seven members of the wider supervision team at the start of the Review Period in January 2005, including the manager, had left the team by time of the interim ARROW in June 2006. This high level of turnover on the team continued throughout the Review Period and, of the seven members of the team in June 2006, including the manager, only two remained on the team by the end of April 2007. This turnover necessitated regular changes in terms of which members of the team had responsibility for each of HBOS's divisions.

1220. High staff turnover also meant more recruitment. Given the broad range of issues the team was responsible for supervising, greater emphasis was placed on recruiting generalist supervisors rather than technical prudential specialists. As a result, there were times, predominantly in the middle of the Review Period, when the team had limited experience of both banking and supervision, especially of the corporate business and Treasury.

1221. It is worth noting that one manager and one team member resigned from the FSA to join HBOS at separate times during the Review Period.(232) Given the greater financial benefits available in the commercial sector, it was, and indeed still is, not unusual for supervisors to join a regulated entity, particularly the large groups. It was MRGD practice to immediately move an individual off the supervision team and on to project work while they worked out their notice period. During the Review Period, there was one other large financial group that two members of the HBOS supervision team joined, again at different times.

(231) The lead associate, for a period also known as the team deputy, was the next most senior person on the supervision team after the team manager. MRGD did not operate with formal deputy managers.
(232) In addition, Mr Oliver Page, FSA's Director of MRGD until April 2006 joined HBOS's Retail Risk Control Committee following his retirement from the FSA.

4.3.7 Involvement of FSA senior management in the supervision of HBOS in the pre-crisis period

1222. As noted previously, the supervision team primarily led key interactions with the firm, with the manager acting as the main point of contact. The supervision team, with support from FSA specialist teams, dealt with day-to-day issues, such as ARROW and C&C meetings, as well as ad hoc work and thematic analysis.

1223. The FSA's Chairman and executive management had some limited interaction with HBOS prior to the financial crisis. This included periodic group meetings arranged by the FSA with the chief executives or chairmen of several systemically important banks, including HBOS, to discuss market topics as a group. FSA senior management attendance at bilateral meetings with HBOS occurred on an ad-hoc, infrequent basis. For example, the supervision team's Head of Department or Director typically led FSA presentations to the HBOS Board following an ARROW assessment and attended annual meetings with the firm to discuss its Business Plan. In general, both of the firm's Chief Executives were available for meetings with the supervision team directly.

1224. FSA senior management were involved in key set pieces, such as ARROW panels and Decision Making Committees (DMC). To illustrate this, Mr Page, MRGD Director until April 2006, chaired the December 2004 ARROW Panel which validated the key judgement to remove HBOS's capital add-on. There was also independent input to the panel from FSA senior advisers. Although it was not standard practice for the FSA Chief Executive to attend ARROW panels, Mr Tiner attended this meeting as an *'observer and not a participant'* as he had not previously attended a panel.

1225. FSA decisions on whether to approve a firm's waiver application to use the IRB approach under Basel II were made by a DMC and involved FSA senior management. The committee drew its membership from supervision, the FSA's specialist Risk Review Department and other departments across the FSA. In line with FSA policy, DMC panel meetings at which HBOS's application was discussed were chaired by a supervisory Head of Department who was independent from the supervision team.

1226. In addition to senior management involvement in these set pieces, there were processes for supervision teams to escalate key judgements or exceptional events, for example via the Watchlist or to the FMC. MRGD had a standing agenda item to update the FMC on key issues. As set out in Section 4.7.4 (Box 4.10), Mr Moore's whistleblowing allegations, together with the supervision team's proposed handling, were reported to the FMC. Other HBOS issues reported to this committee during the Review Period included key senior management changes at the firm, such as the appointment of Mr Hornby as Chief Executive, updates on the development of Corporate's Basel IRB models and various conduct issues, such as HBOS's decision to review mortgage endowment complaints that had previously been declined.

1227. Although the supervision team escalated key issues and judgements, FSA senior management were distant from day-to-day supervision, with only fragments of information going to different individuals over the course of the Review Period. Senior management did not provide sufficiently clear direction to front-line supervisors, track progress or monitor issues over time. FSA senior management did have wide ranging responsibilities and competing calls on their time, both internally and externally, given the large number of firms that the FSA supervised and international commitments. However, overall, this level of engagement by FSA senior management was insufficient, particularly given the absence of a framework for providing senior management with assurance over the quality of supervision during the Review Period. This also undermined the FSA's credibility when challenging a firm's senior management and too much responsibility for identifying and mitigating problems was delegated to supervision team level.

It is clear, not least from interviews with Mr Briault (FSA Managing Director of Retail Markets until April 2008) and Mr Strachan (MRGD Director from April 2006 to April 2008), that senior management in supervision recognised throughout this period that HBOS was heavily reliant on wholesale funding and had significant concentrations in CRE. However, the degree of risk was not seen as an existential threat.

1228. Following the failure of Northern Rock in September 2007, FSA senior management became much more involved in key judgements and delivering supervisory outcomes for HBOS. The FSA Chairman, Sir Callum, and Chief Executive, Sir Hector, also became heavily involved in contingency planning work for HBOS, in particular from March 2008. This is considered further in Section 4.8.

4.3.8 Supervisory relationship with HBOS

1229. Overall, the relationship between HBOS and the FSA was characterised throughout the Review Period as being 'open and co-operative'. It was also, in general, seen as being better than the FSA's relationship with most of HBOS's peers. For example, in May 2006, the relationship with HBOS was described in an internal supervisory note as follows: *'Overall the group has a positive approach to regulation. It is very open with the regulator and routinely shares a large amount of management information with us (probably more than most other groups)'.*

1230. The relationship with the firm, together with the view of HBOS's overall control framework, were key factors in the amount of trust and reliance placed on HBOS senior management, as well as the degree of testing carried out by the FSA. These factors also contributed to a divisional FSA initiative – the 'C&C challenge initiative' – which resulted in the number of open items on HBOS's RMP being reduced from 20 to eight in mid-2006.

C&C challenge initiative

1231. MRGD launched an initiative in late 2005 to benchmark groups' acceptance of the FSA's C&C approach to supervision. Those firms which were considered to be the most receptive to the C&C approach could in effect benefit from a 'regulatory dividend' as a key consideration from the outset was *'whether a strong Close & Continuous relationship with a group could enable us (and other internal stakeholders) to apply less rigorous standards to certain events… This would probably entail our placing more reliance on senior management of groups, where we felt it was appropriate to do so'*. The exercise was also part of the implementation of the new ARROW II approach.

1232. As part of the benchmarking exercise, supervision team managers were asked to consider the extent to which they viewed their firms to be open in their discussions with the FSA and assess the quality of the firm's controls. Of the 34 large groups within the scope of the exercise, HBOS was assessed, along with 13 other firms, to be in the upper quadrant (i.e. those firms deemed to have both good controls and high levels of openness). Scoring for each firm was subject to moderation between managers and agreed by the MRGD Director, Mr Strachan, and divisional Heads of Department.

1233. Based on the outcome of the benchmarking exercise, supervision teams prepared a proposal to reduce the number of open issues on firms' RMPs. This involved identifying items which could be removed from the RMP, thereby trusting the firm's senior management to oversee remediation of the issues involved, with progress to be discussed with the FSA during C&C meetings. Those issues that were considered to pose the most immediate risk were retained on the RMP. The proposals were subject to scrutiny by the MRGD senior management team and the results of the exercise were reported to the FSA's Managing Director of Retail Markets, Mr Briault, in May 2006.

1234. The HBOS supervision team undertook its C&C initiative in spring 2006 and initially proposed retaining six out of the 20 RMP issues that were open at that time. However, the outcome of the C&C initiative was combined with the 2006 interim ARROW review, which culminated in a further reassessment of HBOS's RMP. As set out in Table 4.3, the revised RMP, which was sent to the firm in June 2006 alongside the ARROW letter, included a total of eight RMP items. Four items were rolled across from the previous RMP and four new RMP items were added.

Table 4.3: June 2006 RMP items

RMP item and divisional ownership	Status of issue
Basel implementation – HBOS Group	Transferred from previous RMP but expanded to incorporate actions that had previously been listed as separate RMP items.
Stress testing – Corporate	Transferred from previous RMP, although the emphasis changed to focus more on Basel II. This followed the work undertaken by HBOS in 2005 to stress test its CRE portfolio
Mortgage & General Insurance Regulation – Retail	Transferred from previous RMP
Management of Life Company Funds – Insurance	Transferred from previous RMP
Project Holly – HBOS Group	New RMP relating to an HBOS cost leadership programme
HBOS FS financial accounting, systems and controls – HBOS Group	New RMP
Financial accounting, systems and controls – Insurance	New RMP
Mortgage Endowment Complaints – Retail	New RMP

1235. As a result of this exercise, 16 items from the original RMP were either transferred to C&C supervision or incorporated into the expanded Basel RMP item. Table 4.4 summarises the outcome of this exercise for those issues that are most relevant to this Review. A number of the items transferred to C&C supervision related to conduct or insurance issues, which are outside the scope of this Review, so are not included in the table below.

Table 4.4: Key issues transferred to C&C supervision or the Basel process

Issue and division	Post C&C initiative outcome and explanation
Intra-group exposures – HBOS Group	This RMP sought to ensure that HBOS had clear and robust procedures for approving, managing and monitoring intra-group funding flows. This issue was closed as a separate RMP item but an action was incorporated into the Basel RMP which required: *'HBOS Group Financial to review their integrated groups regime, individual guidance and embedded waivers in line with CRD implementation and FSA guidelines'*.
Credit decisioning process – Corporate	The supervision team viewed HBOS as having enhanced its credit risk decisioning process following the implementation of a new credit decisioning system and a review by Group Risk. As such, the new system was to be monitored through C&C supervision. In addition, an action was included under the Group's Basel RMP which required Group Risk to review the operation of the new system.
Risk grading systems and management information – Corporate	The supervision team considered that Corporate had made progress in developing its credit grading systems and planned to track this through C&C meetings and alongside Basel implementation. In addition, an action was included under the Group's Basel RMP which required the FSA to visit Corporate in 2007 Q1 to discuss the MI for risk management.
Management of credit risk in the unsecured business – Retail	The supervision team considered that progress had been made by HBOS in understanding the underlying causes of poor credit performance in parts of the unsecured book and by significantly increasing the resource devoted to credit risk analysis. Given the significance of credit risk to the division, the supervision team indicated to the firm that it would continue to track the credit trends through C&C supervision.
Overseas operations – Treasury	This RMP sought to ensure that there was adequate control over Treasury's overseas operations in the new Sydney branch, which opened in September 2005. The supervision team acknowledged that work had been carried out to develop the governance, systems and controls and indicated to the firm that it would continue to monitor the growth of the branch through C&C supervision.
Control framework – International	The supervision team considered progress to have been made by the firm in implementing Group Risk's recommendations to strengthen the control environment in International. Following visits to Australia and Ireland, the supervision team indicated to the firm that it would continue to track progress through C&C supervision.

1236. The concept behind the C&C challenge initiative of articulating the outcomes the FSA was seeking to achieve, while giving firms greater discretion on how to achieve these outcomes, was consistent with the FSA's principles-based approach to supervision. It was also intended to make the best use of limited supervisory resource by ensuring supervision teams focused on those issues which were considered to pose the greatest risk to the FSA's objectives.

1237. Following this initiative, the supervision team continued to hold regular C&C meetings with HBOS senior management to assess risks and discuss progress on previously identified issues. However, the initiative did result in key issues being removed from supervision's only formal tracking framework as the discipline of setting milestones for review or deadlines for action to be taken did not apply to the C&C programme. As a consequence, the pace of remediation of issues appears to have slowed. For example, some issues included in the April 2008 RMP – such as the control and monitoring of Treasury overseas branches and personal sector credit risk in Retail, – were broadly similar to issues identified in the December 2004 ARROW and subsequently transferred to C&C supervision in June 2006.

1238. The initiative also resulted in even greater reliance being placed on HBOS senior management and Group control functions to confirm that issues had been addressed, with limited, detailed testing carried out by the FSA. The minutes of a July 2006 HBOS Board discussion about the FSA's ARROW letter and RMP is indicative of the message that was sent to the firm. The ARROW letter was seen as *'a generally positive assessment… The FSA was comfortable to place increasing emphasis on senior management to ensure that business and control risks were properly identified and mitigated'.*

1239. The supervision of HBOS's management, governance, culture and controls, as well as the effectiveness of the supervisory relationship, are considered further in Section 4.7.

4.4 Supervisory approach to asset quality

4

4.4.1 Introduction

1240. This section sets out the FSA's approach to the supervision of asset quality during the Review Period (Section 4.4.2). It then considers the supervision of asset quality and related issues in the following HBOS divisions:

- Corporate (Section 4.4.3);
- International (Section 4.4.4); and
- Retail (Section 4.4.5).

1241. The supervision of Treasury asset quality is considered in Section 4.5, alongside the supervision of liquidity and funding.

4.4.2 Approach to the supervision of asset quality

1242. As identified in *The RBS Report*, the FSA's supervisory approach for the majority of the Review Period involved little detailed assessment of underlying assets or balance sheet structure. Indeed, the former Chief Executive of the FSA, Mr Tiner, questioned in interview whether assessments of individual credit files, outside of checks required as part of the Basel framework, were considered to be the FSA's responsibility at all: '*it would have been quite exceptional for the credit risk review team to go into individual loan files and make individual assessments. I think that is the job of the board and what we should be checking is that the board are doing that*'.

1243. Instead of undertaking detailed assessments of the assets held by HBOS or seeking to deliver substantive change to the firm's risk profile, the FSA placed reliance on the firm's senior management to resolve issues as they arose. This approach contributed to the supervision team not fully appreciating the nature of some of the risks inherent in the assets held by HBOS for much of the period.

1244. The general approach to the supervision of asset quality entailed annual meetings to discuss the firm's business plans and regular C&C meetings in order to assess HBOS's management of this area and how the firm identified and addressed risks. The supervision team also received key pieces of management information, including Audit Committee and divisional Risk Control Committee papers, as well as quarterly credit portfolio reports. However, training for new members of the supervision team did not emphasise reviewing financial data.

1245. Regulatory returns were reviewed centrally by the FSA, rather than at supervision team level. At that time, the information in the regulatory returns was very high-level and contained little detail on the composition or quality of a firm's assets, and reporting of possible breaches or large movements was on an exceptions basis.

1246. As a result, there was little expectation or opportunity for the supervision team to undertake detailed work on asset quality, particularly while Basel II was being implemented. Basel model development was the key area of prudential focus for the supervision team for much of the Review Period, particularly in respect of Corporate.

1247. At the same time, a significant proportion of the FSA's specialist prudential risk resource was absorbed by the Basel II implementation process. This meant that there was limited specialist resource available for asset quality work. There were other options available to the supervision team, such as engaging a Skilled Person. However, as noted previously, this tool was rarely used during the Review Period unless the FSA was deeply concerned by a particular risk.

1248. The cumulative impact of the issues noted above together with other demands on the supervision team's resources, such as the increasing focus on conduct issues, was that routine monitoring of the firm's financial position was often deprioritised by the supervision team.

1249. While the supervision team had identified some key risks, such as the concentration in commercial real estate, rapid asset growth, deteriorating asset quality and weaknesses in risk management, it is difficult to say precisely what difference a more robust supervisory approach would have made to HBOS's balance sheet. It is clear, however, that there were systematic deficiencies in the FSA's general approach.

4.4.3 Supervision of asset quality in Corporate

Background and December 2004 ARROW

1250. The supervision team communicated to the firm in the 2002 ARROW letter that it considered: *'Business Banking and Corporate Banking are targeting growth in new markets at a time of economic uncertainty. Credit risk is clearly the key risk for these divisions and the control infrastructure…must ensure that the credit quality of new business is maintained at an acceptable level'*.

1251. The December 2004 ARROW letter, which followed a detailed review of Corporate, stated that: *'we observe that Corporate Division has made a good start in modernising its techniques for assessing and monitoring credit risk within the business'*. While the supervision team considered that some progress had been made, the ARROW letter stressed that the culture of Corporate lagged the improvements made in the systems being built: *'it should not be underestimated the challenges that the Division faces in terms of delivering the cultural change necessary… We will want to monitor your assessment of progress with the reform agenda as well as experiencing this first hand, for example when we assess preparations for Basel II'*. This concern lay in the fact that, historically, Corporate largely relied on the individual judgement of senior staff to make lending decisions and had only recently agreed with the supervision team to set up an independent credit function. RMP actions were set by the FSA in December 2004 for the division to improve its risk grading, credit decision making and stress testing frameworks.

Supervision of Corporate in the pre-crisis period

1252. Beyond the work on Basel II, for much of the Review Period the supervision team treated Corporate as less of a priority than both the Insurance Division (due to crystallised risk) and Retail (due to the focus on TCF and a range of conduct issues, together with the relative size of its balance sheet compared to Corporate).

1253. On several occasions during the Review Period, the supervision team identified weaknesses which ultimately contributed to the high level of losses in Corporate, such as: concentrations in CRE lending; weaknesses in HBOS's credit rating systems; that asset growth had outstripped controls; and inadequate MI. However, resources available within the FSA which specialised in credit risk were almost entirely devoted to Basel II implementation. This meant there was limited expectation or opportunity for the supervision team to undertake detailed work on HBOS's asset quality. In the absence of a conventional asset quality review of Corporate during this period, the true scale of the risks was not recognised. These issues were eventually either rolled into the Basel II implementation process, in the belief that this programme would cover them adequately, de-prioritised as other issues rose in prominence or reliance was placed on the firm's senior management to address the risks.

1254. Other key risks within the Corporate portfolio were not identified. For example, the supervision team does not appear to have appreciated the risks related to issues such as the division's process for selling down exposures or the nature of single name concentrations.

1255. Mr Cummings was appointed as Chief Executive of Corporate in January 2006 and he advised the supervision team early on that he intended to restructure the Corporate business along asset class lines, up-skill risk staff, improve management information and introduce a more consistent and analytical approach to credit decision-making. This approach was in line with the supervisory priorities and outstanding RMP actions for Corporate.

1256. Notes taken at this time by the supervision team indicate that it was comfortable to rely on Mr Cummings' assurances that weaknesses in the control framework and culture were being tackled. Furthermore, Mr Cummings was considered more open, co-operative and accepting of the FSA's agenda than his predecessor.

1257. In the first C&C meeting with Mr Cummings as CEO designate of Corporate in September 2005, the supervision team raised a number of concerns regarding CRE lending. Specifically, the team was concerned that HBOS was concentrated in both direct and indirect exposures to CRE. It was also concerned that the firm placed undue reliance on the collateralised nature of CRE lending, thus judging it to be inherently low risk. Beyond the work that was underway to stress test this portfolio, which is considered later in this section, there is no evidence that the supervision team followed up these initial concerns with any actions or requirements at that time.

1258. The HBOS Group Business Plan for 2006-2010, produced in 2005, was titled *'targeted growth'*. The supervision team was given assurances that growth in the UK would be measured and, in particular, that *'Corporate – won't be chasing deals'*. This followed a meeting during which Mr Cummings advised the supervision team that Corporate had been consciously scaling back its ambitions in the second half of 2005 as the economic environment had stalled. As set out in Part 2, Section 2.3.4, *'HBOS Group's reported performance: 2004 to 2008'*, the growth rate of loans in Corporate did slow in 2005 and 2006, but started to speed up again from late 2006 see Part 2, Chart 2.38.

1259. Throughout 2007, Corporate's targets grew to compensate for Retail's underperformance. In March 2007, the supervision team again questioned the continued growth of Corporate lending but was assured that the division was growing *'selectively'* and that it was selling down major transactions.

1260. Despite the concern that the Corporate portfolio could contain some high risk loans, the supervision team appeared to rely on the assurances given that growth in Corporate, in particular CRE lending, would be measured and the view that Mr Cummings was a modernising influence, whose objectives were in line with the FSA. As a result of these assurances, together with the heavy focus on Basel II implementation and its supposed benefits, the supervision team did not carry out any in-depth investigations.

Box 4.5: The impact of Basel II implementation on the supervision of Corporate

Basel model development was the key area of prudential focus for much of the Review Period, particularly in respect of the Corporate Division. It was a complex and resource intensive process. As a result, other prudential matters were largely de-prioritised by the FSA in the apparently benign economic environment.

In particular, rather than undertaking detailed asset quality reviews of Corporate, the supervision team focused on the implementation of Basel II and the IRB modelling associated with it. For example, the April 2008 ARROW letter stated that credit risk management had not been explicitly reviewed during the ARROW discovery work and the FSA had '*relied on our recent* [Basel] *IRB waiver review work*'.

Basel II implementation was difficult for Corporate. Its models had a number of weaknesses, including the poor quality of data available, and there remains some doubt as to whether certain products could be modelled at all. There is no evidence that these issues were escalated outside the implementation process or that the supervision team considered whether the difficulties experienced by Corporate were indicative of wider failings in risk management or the governance framework.

These issues are considered in more detail in Section 4.6.3, '*Basel II implementation*'.

1261. As noted previously, it was agreed as part of the FSA's divisional C&C challenge initiative in 2006 that two of Corporate's outstanding RMP actions on credit decision-making and risk grading would be followed up through the C&C or Basel II implementation process. This was communicated to the firm in the June 2006 ARROW letter: '*Credit Control – Corporate has made good progress in developing credit grading systems and enhancing its credit decisioning process and as such we no longer consider specific actions on these points are required in the RMP. We expect that through a combination of our C&C discussions and Basel model review work we will be able to test the degree to which the Division has embedded the credit grading and decisioning systems in its business and is able to use them to track trends in credit approvals and the quality of the back book*'.

Stress testing HBOS's commercial real estate portfolio

1262. As previously stated, the supervision team did not undertake detailed assessments of the assets held by HBOS, but the FSA did focus on ensuring the firm improved its stress testing practices.

1263. The FSA required the firm to stress test its CRE book in 2005. The inclusion of HBOS in this exercise was based on concerns about HBOS's large share of this market. While the CRE portfolio had previously been stress tested in 2003, the FSA considered that this exercise had not been severe enough.

1264. HBOS was asked to apply stress tests in 2005 covering a range of scenarios, including catastrophic events (i.e. those that would result in the failure of HBOS) and the impact of a prolonged recession as had been experienced in Japan. It was also asked to attach probabilities to the scenarios and explain the results, including any implications for Corporate's risk appetite. HBOS argued throughout this exercise that it considered the work to be unnecessary and that the '*stress testing was "over the top" in terms of requirements*'. This was argued on the basis that the firm's lending practices had advanced since the 1990's commercial property downturn and that it considered the Japanese scenario unlikely in the United Kingdom.

1265. HBOS initially produced some high-level stresses in the first quarter of 2005. However, these were not considered adequate and the supervision team advised the firm in May 2005 that the results were insufficient. The firm subsequently undertook more detailed work, which included engaging an external consultancy, Oxford Economic Forecasting, to provide a view on the probability of the various scenarios.

1266. The final results, which were reported to the FSA in November 2005, concluded that each of the scenarios used was highly unlikely, with the catastrophic scenario given a probability of less than one in 100,000. The results of the tests reported to the FSA were:

- the catastrophic scenario implied an incremental loss of £10.2 billion to reduce the total capital ratio to 6%;
- the implied external insolvency rates for the catastrophic scenario (15.3% over one year) and the eradication of HBOS's profits for three years (6.9% over three years) would have been unprecedented by historical standards, with a corporate insolvency rate of 2.8% in 1992 being highlighted as the highest rate in the previous 30 years; and
- the three year recessionary loss was £2.3 billion, which the firm noted as less severe than the outcome of its own stress testing, which delivered a cumulative impairment charge of £3.3 billion.

1267. However, there were a number of weaknesses with the stress testing. For example, a number of assumptions were based on portfolio averages with little consideration of the various concentrations in the portfolio, and so it is not clear that all the conclusions drawn by the firm were appropriate. Moreover, the results illustrate the judgemental nature of these stress tests. The movement in GDP and commercial property prices provided to the FSA for the three year recession (based on the early 1990s) were more severe than the firm's downside scenario, yet the losses in the later scenario were larger. It is unclear what the reason for this was, as it has not been possible to compare the other parameters.

1268. The supervision team relied on the outcome of this work without further verification and advised the firm in July 2006 that it was satisfied with the work that had been undertaken.

1269. It is unlikely that any scenario considered plausible under the intellectual framework of the time would have predicted the events of 2007 to 2009. The FSA was developing its approach and use of stress testing at this time. As set out in *The RBS Report*, the FSA's approach was inadequate for firms of significant scale and complexity, such as RBS and HBOS. It was too focused on whether a firm had carried out a stress test in line with the defined scenario, with inadequate FSA review of the underlying assumptions and results. Furthermore, supervisors had not been trained in how to undertake a review of a firm's stress test which contributed to a lack of robust supervisory focus on stress tests.

1270. While there remained an ongoing need for stress testing as part of the Basel II implementation process, the supervision team does not appear to have pursued its concerns regarding the vulnerabilities of the CRE portfolio any further after the closure of this specific exercise. In retrospect, this represented a missed opportunity to press Corporate to take a more rigorous approach to the risk profile of its largest area of lending exposure.

Supervision's reaction to the deteriorating credit markets

1271. After the failure of Northern Rock in September 2007, the FSA began to consider other firms with similar business models more closely. The heightened risk environment led the supervision team to question the risks to the Corporate business.

1272. As noted previously, during the ARROW review work in late 2007, the supervision team de-prioritised credit risk management and instead reliance was placed on the recent Basel II implementation work. Nonetheless, following the ARROW assessment, credit risk was identified as the second highest priority across the Group (behind balance sheet management) given the exposure to the risks of a downturn.

1273. In spring 2008, the supervision team became increasingly concerned about the asset quality of the corporate lending book. While the overriding prudential concern at this time was liquidity management, a closer scrutiny of credit risk committee minutes led the team to request specific credit files to undertake its own review. Based on this exercise, the team concluded that the quality of analysis undertaken by HBOS was far lower than expected and that some lending was performing worse than expected.

1274. This was particularly highlighted by the supervision team's discovery of an example of Corporate extending further lending to a client that would otherwise have defaulted on its loan repayments. While HBOS sought to downplay this as a 'technical default', the supervision team made a judgement that this indicated the distressed nature of the exposures and that, as the level of exposure increased, the risks also grew.

1275. Based on these concerns, the supervision team asked the FSA's specialist Prudential Risk Department to undertake a detailed review of the corporate lending book. Indicative of the limited specialist resource available at this time and throughout the Review Period, the supervision team had to *'beg them to do this work, because they said they were pulled in every direction to look at different issues and different banks'*. This review concluded in July 2008 that there were multiple, significant weaknesses in the control framework. The scope and conclusions of this review are considered further in Box 4.6.

Box 4.6: FSA specialist review of Corporate credit risk controls – July 2008

Scope of the review
The overall scope of the review was to:

- assess the effectiveness of the management of credit risk in the commercial real estate, leveraged loans and syndication portfolios;
- consider concentration risks within these portfolios and various asset quality trends;
- assess credit quality to identify potential shocks to capital;
- assess the overall view of the market and key sub-sectors, risk appetite, business being written, Basel model output trends, re-financing and delinquency trends, sensitivity and stress testing; and
- review the management information used by these businesses.

The supervision team selected these areas of focus based on its perception that these were the higher risk portfolios: the £9.8 billion syndication book had a £4.5 billion overhang of unsold assets due to the loss of market liquidity; the commercial property book was the largest asset class at £31 billion; and leveraged loans was a large, inherently high-risk portfolio. The review did not cover data quality or consider individual lending decisions.

Conclusions of the review

FSA specialists reported the key findings to the supervision team at the end of July 2008. Overall, the review concluded that: '*Market developments over the past 9 months pose a serious challenge to the HBOS Corporate business model …HBOS face the risk of significant asset quality deterioration. Given the deteriorating economic situation, HBOS must ensure that this exposure is effectively managed, particularly as the structure of the balance sheet is heavily biased to asset classes that may be particularly vulnerable to such a downturn*'.

More specifically, the review concluded:

1. *The effectiveness of HBOS Corporate's credit risk management processes significantly lag those of their peer group'.* This conclusion was underpinned by the following:

   - there were material weaknesses in the monitoring processes which were also mis-aligned with the overall risk management framework;
   - MI on the structure and risk profile of the real estate portfolio was considered to be inadequate for effective portfolio risk management;
   - no industry sector review process was evident in Group Risk;
   - exposures were not being aggregated across the Group;
   - there was a significant exposure to re-financing risk; and
   - there was a proliferation of business risk teams, forums, boards and committees resulting in confusion or overlap of oversight and responsibility. In addition, there was not comparable growth in the back office support.

2. *'Portfolio management has historically been a reactive stewardship function'.* For example, sector limits were not appropriately sub-divided which meant that high-risk asset classes had access to the full Corporate limits. Managing the migration to active portfolio management was considered to present a significant challenge in the prevailing economic environment.

3. *'Syndications / Loan Distribution and hold practices processes are considerably behind market practice'.* This conclusion was based on the following findings:

   - the Loan Distribution (LD) function reported to Risk and not Treasury, as was common in HBOS's peers. As a result it was not responsible for the retained assets and operated at a distance from broader capital market developments; and
   - LD only provided an opinion as to the possibility of transferring credit risk exposure by selling-down part of the risk and did not give a commitment that the sell-down would be accomplished.

4. *'The 'Lumpiness'/ Concentration of the portfolios reviewed … has been exacerbated by the failed distributions'.* As a result, Corporate was considered to be exposed to significant correlated *'fat tail risk'.*

5. *'The higher risk ISAF* [Integrated Structured and Acquisition Finance] *and RE* [Real estate] *Joint Venture businesses are significant within Corporate. In both these businesses asset quality issues are emerging. We have concerns that the Impaired Asset function is not resourced to deal with the complex challenges that 'working out' distressed assets in these classes will pose'.*

6. *'Corporate may not be subject to adequate challenge from HBOS Group'*. This conclusion was based on the following findings:

- HBOS Group had no involvement in, nor did it challenge, Corporate's decisions to retain or transfer credit exposures;
- there was no evidence that Group had appropriately considered the concentration risk arising from aggregated real estate exposures and as a result did not provide robust challenge; and
- it was not clear what influence Group had in relation to large transactions, particularly those that significantly increased correlated or sector risk.

The issues identified were considered to represent serious weaknesses in the prevailing market environment and of such significance that addressing the underlying issues posed considerable management challenges.

The review acknowledged that a number of strategic responses were being progressed (such as scaling down the ISAF business) and that HBOS was taking action to address the issues identified by the FSA, but noted concern as to the timeliness of implementing solutions. In particular, the review noted that middle management did not seem to have an appreciation of the challenges that recent market developments posed to the Corporate business model.

Although the review did not include a detailed calculation of the potential for capital shocks, it did conclude that the risk to capital was on the downside, significantly so in the case of the ISAF business, and would be exacerbated by any economic contraction.

1276. Weaknesses identified by the FSA specialist review had evolved over a number of years resulting from Corporate's failure to fully appreciate the risks and implement appropriate mitigation. While the full extent of some of the weaknesses may have only become apparent in the crisis period, had a similar in-depth review been carried out by FSA specialists at an earlier date, a number of governance and control weaknesses may have been identified, giving more time and options for resolution.

1277. The supervision team discussed the findings of the review with HBOS directors and senior managers during C&C meetings held in summer 2008 and sent Corporate an extensive, revised RMP in October 2008 to address the weaknesses identified. This identified governance, credit risk management, operating controls and IT systems as high risk areas for the division.

4.4.4 Supervision of asset quality in International

1278. The International Division received a lower degree of supervisory attention than the Corporate and Retail businesses during the Review Period. While the FSA was the consolidated supervisor for HBOS Group, where possible, the supervision team relied on local regulatory authorities, for example in Australia, Ireland and North America, to provide regulatory oversight.

1279. The key issues that the supervision team focused on were common to all three International businesses: Australia; Ireland; and Europe and North America (ENA). The supervisory concern was the effectiveness of the governance and controls applied to HBOS's overseas operations in the context of rapid growth in these regions. In line with the FSA's overall approach at that time, the supervision team did not, however, undertake any substantive analysis of International asset quality.

1280. The December 2004 ARROW identified that: '*the planned development of the group's international operations in Ireland and Australia is another area of potential risk to the group*'. Reflecting this concern, an RMP action was set for HBOS to improve the controls relating to both Australia and Ireland. This required Group Risk to review the effectiveness of the controls, locally and in the UK, and for the supervision team to visit both operations.

1281. HBOS's international growth plans were reaffirmed in its Group Business Plan for 2006-2010 and the June 2006 ARROW letter summarised the supervision team's view that: '*the aggressive overseas growth plans poses risks to the whole group. We want to be satisfied that the Group and its senior management manage and mitigate appropriately the risks arising*'.

1282. In view of the complexity and geographic diversity of HBOS's overseas operations, the supervision team's approach was to place reliance on the Group in terms of the governance and oversight of the overseas operations. The rationale for this strategic approach was reasonable given the approach to supervision at the time, especially as members of the HBOS senior management team, including Mr Crosby, openly shared the team's concerns. Group Risk also regularly reviewed, or declared an intention to review, the controls, as did KPMG for Australia. However, the supervision team did encounter some practical difficulties, described below.

Reliance on HBOS senior management and Group Risk

Australia

1283. Following a visit to HBOS Australia (HBOSA) in February 2005, the supervision team met Mr Matthew, Chief Executive of Strategy and International, in April 2005 to discuss the key findings. During this meeting, the supervision team fed back its concerns regarding the complex governance structures, low levels of expertise in some key areas, management stretch and the management of credit risk in new markets.

1284. These findings had also been discussed with Group Risk in March 2005, which concurred that '*Australia was dangerously close to running too fast*'. While the FSA was aligned with Group Risk, most of the supervision team's concerns were challenged by Mr Matthew. The FSA recorded that Mr Matthew '*made clear that he thought our views were not fully informed given the short period of our visit*'.

1285. The supervision team followed this up during a meeting with Mr Crosby in June 2005. Mr Crosby was sympathetic to the supervision team's view of HBOSA, describing its structure as fragmented, but he felt that Mr Matthew's response was simply a '*presentational/ communication issue with Colin* [Matthew] *and that he was simply unsure of his ground as to how far he could go when discussing issues with the FSA*'.

1286. A review by Group Risk, which had been required by the RMP action set in December 2004, identified many similar issues to those raised by the FSA. It highlighted complex governance structures, resource stretch, management information and working relationships with the rest of the Group as issues of concern in both Australia and Ireland. On this occasion, the recommendations were accepted by the business as valid issues to be addressed and an action plan was put in place.

1287. Despite the assurance that remedial action would be taken, the supervision team remained sceptical about the effectiveness of controls in International and the lack of openness of Mr Matthew compared to the other divisional CEOs, However, the Review found no evidence that this scepticism was supported by a more robust supervisory approach at this time.

1288. A second supervisory visit to Australia took place in March 2007. On this occasion, the supervision team's feedback was far more positive, describing the HBOSA staff as '*open and* *accommodating'*. At the same time, it was acknowledged that the positions of Head of Risk, IT and HR were all vacant, but the Review found no evidence that the supervision team required the firm to take any action to rectify that situation, other than stating that people was a key risk.

1289. In October 2007, Group Risk advised the supervision team that the Australian credit team lacked the required skills and that Group Risk would be conducting a review of its effectiveness in 2008. However, other events had taken over in 2008 and no evidence was found that the supervision team discussed this issue any further with the firm.

Ireland

1290. The supervision team was similarly concerned about the controls in the Irish business due to its rapid growth. The Irish market proved not to be as sophisticated as the UK banking market and the rapid growth appeared to outstrip available staff resources, with other parts of the HBOS Group reporting to the supervision team that Bank of Scotland Ireland (BOSI) had attempted to poach staff.

1291. Records have been found of two visits to Ireland by the supervision team during the Review Period. The first visit took place in March 2006 and the second in December 2007, as part of the ARROW assessment. As in other areas, the supervision team's discussions about the Irish business were characterised by reassurances from senior management that the risks were being managed. Following the 2005 review by Group Risk, an action plan was put in place to address concerns about the controls in Ireland, as well as Australia. Indeed, following this 2005 review, the firm reported to the supervision team that its Irish retail expansion plan, based on the purchase of a network of former Electricity Supply Board showrooms, had been completely re-planned. The supervision team was also informed in February 2006 that Group Risk was visiting Ireland fortnightly to oversee progress.

1292. Following the ARROW review work in the last quarter of 2007, the supervision team came to the view that, while it was comfortable with the risk and control framework underpinning the Irish retail expansion programme, it wished to remain close to the roll out of the remaining branches.

1293. The supervision team also set an RMP action in April 2008 for the FSA to review HBOS's proposal to create a separate Corporate division in Ireland while also broadening its asset classes within this portfolio. The RMP recorded that: *'Whilst we have already received assurances from BOS(I) senior management that they possess the appropriate skills to manage any increased risk arising from this initiative, we wish to increase our understanding of the proposals, once fully finalised, including the risks identified, any mitigating actions proposed and how the proposals will impact the balance sheet'*.

Europe and North America

1294. ENA faced a similar issue to HBOS's businesses in Australia and Ireland – the need for controls to match its expansion. ENA was a complex mix of businesses whose only common feature was their non-UK, Australian or Irish jurisdiction. HBOS senior management needed to understand a wide variety of businesses and their respective markets, which included: Banco Halifax Hispania, a Spanish mortgage provider; Clerical Medical Europe, an insurer; and Bank of Scotland USA, a corporate lender focused on the gambling, oil and gas, and broadcasting industries.

1295. Appropriate to its size, ENA received the least supervisory attention throughout the Review Period, although there is evidence that the supervision team discussed certain risks inherent in this part of business with HBOS senior management. Having conducted a series of ARROW meetings in the last quarter of 2007, the supervision team noted that the risk and control functions within ENA appeared to have grown commensurately with the business. However, concerns about ENA's ability to manage large projects adequately and its plan to embark upon a further project to extend the division's footprint in Germany led to the establishment of an RMP action for ENA in April 2008. The RMP stated that ENA senior management should present to the FSA on the rationale of the project, including business plans, governance and requirements for an enhanced control framework.

1296. The first detailed discussion beyond broad business updates with ENA senior management appears to have been in June 2008 when a meeting was arranged to gain an understanding of *'the degree of credit risk in Europe and North America'*.

Reliance on local regulatory authorities

1297. While the FSA was the consolidated regulatory authority for the HBOS Group, as noted previously, a considerable amount of reliance was placed on local regulators, as well as Group Risk, to provide oversight of HBOS's International businesses.

1298. In respect of Australia, there appears to be some ambiguity in the FSA supervision team's understanding as to the limits of the Australian Prudential Regulatory Authority's (APRA) prudential supervision of HBOSA, in particular as regards unregulated activity such as corporate lending. This posed a challenge to effective supervision of the entire HBOS Group by the FSA. The division of responsibilities was discussed at several meetings between HBOS and the FSA, and the supervision team regularly sought to agree a division of responsibilities. However, the Review found no evidence of such discussions resulting in clarity. The supervision team did visit Australia twice during the Review Period, but the focus was on governance and controls.

1299. Records indicate that the firm obtained authorisation in 2005 to facilitate consolidated oversight of HBOSA entities by APRA. An HBOS Australia Strategic Review paper set out that: *'A component of the legal formation of HBOSA was the application to APRA for Non-Operating-Holding-Company (NOHC) status. This is a pioneering regulatory position for Australia, which effectively combines the regulated (BankWest, St Andrews) and the non-regulated (Capital Finance, BOSIAL) entities into an arrangement to allow effective oversight by the Australian Regulator. APRA formally approved the NOHC application on 6 July 2005'*.

1300. However, APRA advised this Review that, other than Basel II accreditation work, its prudential supervisory authority only extended to Authorised Deposit Institutions (ADIs) and regulated life and general insurance – in the case of HBOS Australia this meant BankWest and the Sydney branch of HBOS Treasury Services. APRA also indicated to this Review that its responsibilities towards Bank of Scotland International (Australia) Ltd, which undertook corporate lending, extended only to gathering information to be passed on to the Reserve Bank of Australia.

1301. BOSI was regulated by the Irish Financial Services Regulatory Authority (IFSRA) and the supervision team looked to the local regulator to be the primary source of supervision. [redacted] (233)

1302. HBOS's US bank branch was regulated by the Office of the Comptroller of the Currency (OCC), although due to the relatively simple nature of this branch the OCC's oversight of it was limited. It is unclear to what extent the FSA supervision team understood the limited nature of the OCC's supervision of the branch and relied on it.

(233) This text has been redacted because it contains confidential information for which consent to disclosure was required from Central Bank of Ireland: that consent was not received.

4.4.5 Supervision of asset quality in Retail

1303. The supervision team generally treated the Retail business as a higher priority than the other divisions. The implementation of Basel II was less of an issue for Retail as this division did not suffer the same degree of difficulty as Corporate in gathering reliable data or building appropriate models.

1304. However, key areas of focus were dominated by conduct issues, such as PPI and mortgage endowment complaints, as well as the FSA's TCF project. Conduct issues were discussed frequently at C&C meetings with both Retail and Group senior management and in numerous ad hoc meetings, visits and telephone calls with the division.

1305. Nonetheless, the supervision team regularly discussed the condition of the mortgage market, the progress of the economic cycle and rising impairments with Retail senior management. Indeed, the tone of the supervisory relationship with Retail throughout the Review Period was characterised by the division's openness with the FSA that the markets it operated in were slowing and that it could expect increasing impairments in the short-to-medium term.

Provisioning in the unsecured lending book

1306. Reflecting the FSA's house view at the time, the December 2004 ARROW letter referenced that *'the housing market has slowed considerably in the last 3 months which as well as having direct mortgage book implications could lead to a more general reduction in consumer confidence'*.

1307. The December 2004 ARROW letter also included an RMP action for Retail to work on a project to improve its credit risk function and, in particular, the provisioning in the unsecured book. This required the firm to ensure that '*the dynamic behind … losses are fully understood and provided for*'. As part of MRGD's C&C challenge initiative (see Section 4.3.8, '*Supervisory relationship with HBOS*'), it was agreed in spring 2006 that this RMP action would be closed and transferred to C&C supervision on the basis that: *'the firm has greatly expanded the amount of resource it devotes to credit risk; newly introduced scorecards appear to be functioning well'*.

1308. Mr Benny Higgins, who succeeded Mr Hornby as CEO of Retail in May 2006, said during an interview for this Review that he informed the supervision team in spring 2007 that he thought the unsecured personal lending book was being systematically, though not deliberately, under provisioned (i.e. that insufficient reserves were being set aside for future losses). No note for record of this meeting has been found or of any actions taken by the supervision team in response to this, although the supervision team did file a copy of a presentation given by the firm around the same time which noted the issue and highlighted actions that the firm planned to take to remediate it. Mr Higgins also said that he mentioned the issue again in an *'off the record'* interview with the FSA in autumn 2007 to discuss his departure from HBOS, explaining that he was surprised that there was not a more active response from the FSA. He recalled the Head of Department saying that this was partly due to prioritisation of resources at that time. Again, no minutes of this meeting were found. While the Review has not been able to ascertain a clear picture about what the supervision team was told by the firm and how it responded at the time, the suggestion that this issue was given relatively low priority is consistent with other evidence outlined in the Report of the low priority given to prudential issues outside the Basel II implementation programme before the onset of the financial crisis.

Churn in the mortgage book

1309. As set out in Part 2, Section 2.6, *'Asset Quality – Retail Division'*, another central issue for Retail was the level of churn in the mortgage book and its impact on profitability. This was a regular topic of discussion between the supervision team and HBOS during the Review Period. In early

2005, the supervision team was advised that the mortgage book was churning by around 40% every year.

1310. Mr Higgins devised a strategy to improve pricing and alter broker incentives (as 85% of the mortgage portfolio was derived from brokers) in an attempt to improve retention. This strategy, pursued from mid-2006 to the summer of 2007, ultimately was not successful. Mr Higgins left HBOS in August 2007 and Mr Hornby noted in an email to the supervision team that his departure '*was in no way specifically linked to the performance of our mortgage business (indeed, most of the changes which have taken place to the profitability of our mortgage business would have occurred regardless of who had been in charge of the Retail business)*'.

1311. The failure of this strategy had a number of implications which resulted in the firm's risk profile increasing. For example, the poor performance of Retail was one factor which led to increased profit targets in Corporate in 2007. While supervisors were not expected to question the strategies followed by firms, the Review found no evidence that the team considered the wider implications of the success or failure of this strategy.

Approach to rising impairments

1312. The retail book saw more crystallised risk in the form of higher impairments and losses during the period and there was a heightened awareness of the position within the cycle.(234) Rising losses and the growing acceptability of personal insolvency in society were regularly discussed at Retail C&C meetings. This was particularly the case during 2006 as unsecured impaired loans rose as a proportion of the total unsecured book, before falling back in 2007 prior to the failure of Northern Rock. This issue was noted in C&C meeting records as a growing problem and Retail senior management regularly advised the supervision team that they expected it to get worse before it got better.

1313. Retail senior management were more conservative in their characterisation of the outlook than those in Corporate in the sense of new lending not being seen as a remedy for the old loans. The supervision team was advised that the impairment figures in the secured book were within expectations, given it had a bigger exposure than peers to 'non-traditional' mortgages. Rising impairments in 2005 and 2006 were also blamed on an identified bout of poor lending in 2002 and 2003, although there was also an acceptance that the rising figures had exposed *'rusty processes'*.

1314. The Review found no evidence that the supervision team challenged this analysis. It also seems that, when impairments and losses stabilised and then fell in early 2007, both the firm and the supervision team drew comfort that the book had performed well.

(234) In a January 2006 briefing ahead of a meeting with the firm to discuss its Group Business Plan for 2006-2010, supervision highlighted the risk of HBOS increasing its share of the credit card market 'in this stage of the economic cycle'.

Box 4.7: FSA thematic work

Thematic reviews, which examined a particular issue across a number of firms, were a key part of the FSA's supervisory approach during the Review Period. These reviews were intended to inform peer analysis, the allocation of resources and improve the focus of supervision on the most important and emerging issues.

HBOS's Retail Division was regularly subjected to thematic reviews on a wide range of issues during the Review Period.(235) These reviews included PPI (May 2006), Customer Indebtedness (November 2006), Mortgage Arrears and Repossession Handling (April 2008) and Buy-to-Let lending (June 2008).

Although these reviews were focused on conduct issues, they could have potentially raised concerns regarding the quality of various Retail portfolios or the firm's controls in those areas.

In cases where relevant prudential issues were highlighted, the Review found little evidence of follow up by the supervision team after the initial feedback was provided. For example, following the Customer Indebtedness review in November 2006, the supervision team wrote to HBOS feeding back that one of the models used to sanction unsecured lending did not predict the ability of the borrower to repay. The Review found no evidence that the supervision team followed up on this finding through any supervisory action.

As well as a lack of follow up on identified issues and a skew towards conduct risks, these reviews had a diversionary impact on day-to-day supervision of individual firms as they relied on supervisory resources to implement them, even when led by specialist departments in the FSA.

There is evidence that there were many problems with the effective use of thematic reviews across MRGD, which included the HBOS supervision team. Not only did they absorb supervisory resource, but FSA senior management were often unaware of which reviews had been commissioned, their purpose or who would be carrying out the work.

Individual thematic reviews produced valuable and insightful analysis. However, this uncoordinated approach to the programme as a whole may have impacted the supervision of HBOS (which was subject to a high number of these reviews), contributing to the lack of follow through on relevant issues when raised and increasing the possibility of mixed messages being delivered on FSA priorities.

(235) For example, a 'stock take' done by the supervision team in May 2008 showed that the firm was subject to ten current or planned thematic reviews at that time. In 2005 an internal paper showed that HBOS were included in eight of the thirteen projects planned for the next six months in MRGD.

4.5 Supervisory approach to liquidity and Treasury asset quality

4

4.5.1 Introduction

1315. This section considers the supervision of HBOS's liquidity risk and Treasury asset quality during the Review Period. It covers:

- the FSA's regulatory approach to liquidity (Section 4.5.2);
- resource and supervisory approach to liquidity risk in HBOS (Section 4.5.3);
- supervision of HBOS's liquidity and treasury assets in the pre-crisis period (Section 4.5.4); and
- supervision of HBOS's liquidity and treasury assets in the crisis period (Section 4.5.5).

4.5.2 The FSA's regulatory approach to liquidity

1316. As set out in *The RBS Report*, the regulatory regime that was in place for liquidity prior to the financial crisis was severely flawed and the supervision of liquidity risk was assigned a relatively low priority by the FSA at that time.

1317. In 2003, the FSA recognised that there were a number of limitations in its liquidity regime. The FSA's Prudential Sourcebook requirements at that time followed the Sterling Stock Liquidity Regime(236) which was open to a number of criticisms as it: focused solely on the very short term (a one week period); only applied to sterling; only accepted a narrow range of assets as stock liquidity assets (which had some undesirable behavioural and market structural consequences); and was not representative of the way banks actually managed liquidity risks.

1318. The FSA published a Discussion Paper titled, *Liquidity risk in the Integrated Prudential sourcebook: a quantitative framework* (DP24) in October 2003 which set out a range of proposals that were aimed at addressing the limitations in the regime and establishing a more consistent approach to liquidity risks across the industry. However, feedback from the banking sector described the ideas as:

- too prescriptive and detailed;
- placing too much weight on setting hard quantitative limits as opposed to developing the concept of placing the onus on a bank's senior management to form a view, subject to regulatory review, as to the bank's liquidity needs;
- creating new divergence between the regulation of liquidity risk and the way it was managed by banks; and
- creating a UK regime significantly out of step with emerging regulatory trends.

(236) The Sterling Stock Liquidity Regime required large banks to hold a pool of high-quality sterling liquid assets large enough to survive for at least five working days, without renewal of maturing wholesale.

1319. The proposed changes were therefore not taken forward and domestic reform of the regulation of liquidity was de-prioritised while the FSA awaited the outcome of international work in this area.

1320. The FSA did implement planned revisions to its Pillar 2 requirements, which came into effect in January 2005.(237) This required banks to:

- carry out stress testing and scenario analysis of their liquidity needs;
- put in place contingency funding plans for dealing with a liquidity crisis; and
- document its liquidity risk management policy.

1321. In September 2006, following the start of international reviews of liquidity risk management, the FSA's Prudential Standards Department proposed a broad strategy for entering initial international negotiations in a paper to the RPC. This paper stated that: '*Our longer-term aim is to propose a new liquidity regime that addresses the prudential concerns raised by liquidity risk. The existing regimes are acknowledged to be deficient, but not sufficiently so to warrant immediate action without international consensus'*. The minutes of the RPC meeting recorded that: *'RPC agreed with the proposals in the paper, in particular that the FSA's aim was to apply minimal prescriptive requirements and that it would prefer a principle based approach'*.

1322. The September 2006 RPC paper also noted that: '*Liquidity is primarily an institution specific risk which cannot be addressed by a one-size fits all framework. We should therefore place high reliance on senior management responsibility'*. This reflected the view that responsibility for the supervision of a firm's liquidity risk was within the remit of supervision teams but endorsed the approach whereby reliance should be placed on a firm's senior management.

1323. There was a step change in the FSA's focus on liquidity risk from autumn 2007, following the onset of the financial crisis. Liquidity monitoring was significantly enhanced and greater attention was devoted to liquidity issues. With market conditions for liquidity worsening significantly, the FSA Chairman, Sir Callum, made the other Tripartite authorities aware in November 2007 that, while the FSA would continue to exert all the pressure it could to encourage prudent action by firms at risk, it could not be expected to succeed in preventing a further incident through individual firm-specific actions. This recognised that, once liquidity strains had developed, it would be difficult for an individual firm to correct its position quickly, as any action could itself trigger an adverse market reaction.

1324. In December 2007 the FSA published a discussion paper titled, *Review of the Liquidity Requirements for Banks and Building Societies* (DP07/07) which again highlighted some fundamental flaws in the FSA's regulation and supervision of liquidity, including:

- the fact that it had less relevance for 'chronic' liquidity stresses as opposed to 'shock' events. Chronic stresses were defined as being less severe and longer in duration than shock stresses;
- non-sterling and off-balance sheet contingent liabilities were excluded from the sterling stock calculations;
- it allowed the use of certificates of deposits to offset wholesale sterling liabilities by up to 50% with a 15% 'haircut'. In stress conditions these became illiquid and involved claims on other banks;

(237) In accordance with Consultation Paper 128 and subsequent Policy Statement.

- it only required firms to consider a 5% outflow of retail deposits over a five working-day period, which was inadequate as the experience of Northern Rock demonstrated; and
- the applicable section of the FSA Handbook (SYSC 11) was mostly guidance placing the onus on firms to assess the scale, nature and complexity of their activities.

4.5.3 Resource and supervisory approach to liquidity risk in HBOS

1325. Reflecting the low priority assigned by the FSA to liquidity issues in the pre-crisis period, responsibility for the supervision of HBOS's Treasury Division and liquidity was given to relatively new or junior members of the supervision team (often graduate trainees). Treasury was seen as self-contained and liquidity low risk such that this was regarded as a safe area in which new members of the team could learn about HBOS and supervision. High turnover on the supervision team also meant that there was little continuity in terms of who had responsibility for this portfolio.

1326. Limited training was provided to supervisors on liquidity issues in the pre-crisis period and learning was largely derived through on the job training, with some input from more experienced members of the team. The lack of training in this area was highlighted in a paper to ExCo in August 2007: *'Supervisors' lack of familiarity with liquidity issues was recognised some time ago and a training programme has been devised (the early courses have already been run)'*.

1327. Consistent with the FSA approach, the HBOS supervision team focused on the governance component of the liquidity regime and placed reliance on HBOS management to assess and manage adequately the bank's liquidity risk and ensure compliance with prevailing FSA liquidity standards.

1328. The analysis of regulatory liquidity returns was undertaken centrally and the results would have been provided to the supervision team on an 'exceptions only' basis. The supervision team therefore relied on information provided to them by the firm.

1329. While there was increased focus on liquidity from September 2007 following the failure of Northern Rock, the ability to undertake this work most effectively was hampered by the shortage of staff across the FSA with the right skills given liquidity had not previously been a key area of focus.

4.5.4 Supervision of HBOS's liquidity and Treasury assets in the pre-crisis period

Context prior to the Review Period

1330. As part of the 2002 ARROW assessment, the supervision team noted that assets had outstripped growth in customer deposits. Given the associated liquidity risk, it was considered that HBOS needed *'a robust plan which will ensure adequate access to wholesale funding'* and that this was likely to require a diversification of funding away from traditional markets. Reflecting these concerns, an RMP action was set which required the firm to present its funding plans to the regulator and for the FSA's Risk Review team to assess liquidity management in Treasury.

1331. By the time of the January 2004 interim ARROW assessment, the supervision team still had concerns about the Group's large wholesale funding requirements and the RMP action on funding and liquidity management remained open. The ARROW letter also identified the funding of HBOS's Grampian conduit[(238)] as posing significant operational, market and reputational risk. As a result, Internal Audit was directed to review the control framework applied to Grampian.[(239)]

1332. The supervision team recorded in a briefing, dated 23 March 2004, that: *'it is clear they* [HBOS] *recognise the extent of the reliance on wholesale funding and have done considerable contingency planning around it. It is also clear that they are serious about restricting divisions' asset growth if they do not meet self-funding targets. This provides some comfort but we will need to monitor how effectively they mitigate the risk in practice'*. The supervision team considered that sufficient progress had been made during 2004 such that funding was not mentioned in the December 2004 ARROW letter and the team placed greater reliance on HBOS senior management to assess and manage the risks.

1333. This approach appeared to be supported by the findings of a series of risk identification meetings with the senior management of leading banks in the second half of 2004. This piece of work found that liquidity risk was a strong area of focus for HBOS and the prudential limits applied by the firm were seen to be more stringent than the FSA's requirements.

1334. In addition, the supervision team was given assurances by HBOS senior management, during a meeting with Mr Crosby and Mr Mike Ellis, Group Finance Director, in March 2004, that they were aware of the risks and were actively managing them. The actions taken included: improving HBOS's liquidity position by lengthening the maturities of its holdings; taking steps to limit growth; and achieving greater diversity by offering a wider range of Treasury products.

Key areas of focus in the pre-crisis period

1335. Despite the apparent progress that had been made during 2004, the supervision team still had some concerns at the start of the Review Period about HBOS's reliance on wholesale funding, which remained very large in absolute terms (£220 billion). These concerns were set out in a briefing to the supervision team's Director, Mr Page, in advance of an annual meeting to discuss HBOS's Group Business Plan for 2005-2009 on 7 January 2005. The briefing identified the key risk of HBOS not being able to access the wholesale funding market for a prolonged period of time. The supervision team also questioned the viability of Treasury's contingency plans to cover this by lengthening the maturity of wholesale funds and increasing its range of products.

1336. While the minutes of the business plan meeting recorded that there was insufficient time to discuss these risks in detail on this occasion, the supervision team appeared to have a reasonable understanding of the Treasury and liquidity risks within HBOS in the early part of the Review Period. For example, in addition to the firm's reliance on wholesale funding, the supervision team had identified that:

- there was a lack of clarity over the respective responsibilities of Treasury and Group Risk concerning credit and market risk originating in the Treasury Division;
- Treasury providing an increased range of products to the business presented a risk; and
- local self-funding requirements, set by APRA, meant the effective closure of HBOS Australia as a source of funding to the Group.

1337. The supervision team continued to place reliance on HBOS to address the risks involved. HBOS senior management provided assurances to the supervision team that its reliance on wholesale funding was being reduced and that the Group had planned a number of initiatives to optimise

(238) Grampian was a credit arbitrage conduit: see Part 2, Section 2.8.3, 'ABCP conduits: Grampian and Landale'.
(239) HBOS Internal Audit report dated 29 June 2004 concluded that the control environment was satisfactory for Grampian.

its funding. These included a new Asset and Liability Management (ALM) model in 2006, development of a structured medium term note, and private placement covered bond. But, at the same time, Treasury was still forecasting a significant increase in wholesale funding going forward. The Review found no evidence of the supervision team challenging the firm on these apparently contradictory statements or requiring the firm to take any further actions.

1338. Following the 2006 interim ARROW assessment, the supervision team set no RMP actions in respect of Treasury or liquidity and funding. The ARROW letter dated 29 June 2006 stated that: '*The FSA acknowledges the work that HBOS has undertaken to deliver the Treasury risk mitigation programme and as a result of this we have not thought it necessary to include any RMP actions for the division. Instead we will rely on a C&C dialogue which we would expect to include coverage of: Systems and Controls, Compliance Monitoring, and the Australian Branch'*. This was consistent with the MRGD C&C challenge initiative to focus on fewer RMP issues (see Section 4.3.8, '*Supervisory relationship with HBOS'*).

1339. By contrast, the results of a separate, concurrent work-stream across MRGD firms to assess compliance with the FSA's Prudential Sourcebook found in June 2006 that HBOS, while not an outlier, was not fully compliant with the revised Pillar 2 requirements introduced in January 2005. The Review found no evidence that the results of this workstream were communicated to HBOS.

1340. During this period, the Treasury function appeared to increase its risk profile. For example, the minutes of a C&C meeting on 18 October 2006 with Mr Lindsay Mackay, HBOS Treasury CEO, noted that the Treasury profitability plan had been revised upwards twice that year. The Review did not find any evidence of the supervision team questioning whether this was appropriate for a liquidity function.

1341. The supervision team continued to have concerns about HBOS's reliance on wholesale funding and in early 2007 had begun to form a more integrated view of risks to the business. A briefing note dated 14 January 2007 for the MRGD Director, Mr Strachan(240), in preparation for the annual meeting to discuss HBOS's Group Business Plan for 2007-2011, highlighted a number of inconsistences and areas of concern. These included:

- the firm claimed to be focussing on low risk markets while planning to increase its investment in leveraged private equity, commercial property and continued heavy exposure to short-term wholesale funding markets;

- the firm was running close to the maximum capacity for wholesale funding and the funding gap was predicted to grow by nearly two-thirds;

- despite Treasury placing hard limits on Group asset growth and emphasising Group asset quality, –the business plan still envisaged strong growth in the corporate and asset management areas of the business. In a briefing note in preparation for the meeting the supervision team stated: *'Treasury will be under increasing pressure to access new funding markets to support not only planned growth but also to exploit new growth opportunity as and when they arise';* and

- the Group was susceptible to shocks in the wholesale funding market and there were questions as to how reliant the plan was on Treasury finding new sources of funding.

1342. Again, the Review did not find any evidence of the supervision team or FSA senior management requiring the firm to take any specific action to address these concerns.

(240) Mr Strachan became MRGD Director in April 2006, replacing Mr Page, who left the FSA in February 2006.

1343. A July 2007 thematic review on liquidity found HBOS's liquidity management to be broadly consistent with its peers. The review did, however, identify two specific areas of concern:

- HBOS did not assess the implications of a scenario that specifically looked at denial of funding from the wholesale markets, although this concern was not unique to the firm; and
- HBOS had a relatively short funding maturity profile compared to its peers and, as a consequence, the Group was rolling significantly higher overnight positions (at the end of September 2007, 20% of wholesale funding – c.£40 billion in absolute terms – was less than one month). This problem was compounded by the Group being close to its funding capacity and more reliant on the wholesale market compared to its peers.

1344. The supervision team had previously identified the funding maturity profile as a potential issue and it had received assurances from HBOS senior management that the risk was being managed. Nonetheless, the outcome of this thematic review led the supervision team to focus on these two areas of concern in late summer 2007 as part of the SREP to assess HBOS's capital requirements.

4.5.5 Supervision of HBOS's liquidity and Treasury assets in the financial crisis period

1345. The start of the financial crisis represented a step change in the intensity of the FSA's approach to liquidity risk in the banking sector. This was reflected in the supervision of HBOS, which was identified in August 2007 as one of a number of firms that were particularly vulnerable to the market disruption, although the main focus initially was on the firm's liability management and funding.

1346. Much greater emphasis was placed on monitoring HBOS's liquidity and funding position from autumn 2007 with the introduction of weekly, and later daily, funding calls as well as enhanced reporting via the Current Status Indicator (CSI) report and the Liquidity Risk Profile (LRP).(241) Additionally, the supervision team met more frequently with HBOS to discuss and challenge its funding plan.

1347. The firm also established a Contingency Planning Group in September 2007 to look at its ability to respond to a liquidity crisis. The supervision team reported in a briefing to the FSA Chairman, Sir Callum, in October 2007 that HBOS remained confident of its liquidity position, that it had reduced its reliance on short-term wholesale funding and that HBOS had more diversified funding than Northern Rock, B&B and A&L. In relative terms, this assertion was reasonable. However, in absolute terms, HBOS's exposure was significantly higher than those firms. It was this scale and HBOS's ability to raise the necessary volume of funding in the market which represented the most significant risk.

1348. HBOS was added to the FSA Watchlist, along with a number of other firms, in October 2007 due to its potential susceptibility to the market-wide tightening of liquidity.

1349. At a meeting with Group Credit Risk on 25 October 2007 it was noted that Treasury had incurred some mark-to-market losses, which is an indicator of the quality of assets held. HBOS advised the supervision team there *'was no serious risk foreseen on ultimate repayment'*.(242)

(241) The CSI and LRP were both enhanced mismatch reports on liquidity.
(242) As noted in Part 2, Section 2.7, Asset quality – Treasury Division, the liquidity investment portfolio continued to maintain a high credit rating throughout the financial crisis, although the realisable value of these assets in 2008 when they were needed to provide liquidity was significantly below the value expected of them.

1350. The supervision team's priorities towards liquidity and treasury asset management were set out in a pack for the SREP validation panel, which took place on 8 November 2007. The supervision team did not see a need to apply additional capital requirements for liquidity. The supervision team did, however, recommend to the SREP planning panel that the concerns raised in the July 2007 thematic review about HBOS's stress tests and its funding maturity profile, should be addressed by further FSA thematic work as well as through close monitoring of HBOS's future funding plans by the supervision team.

1351. The SREP panel agreed with the supervision team and two RMP actions were set in December 2007 which required HBOS to:

- submit liquidity stress tests focussing on the lack of access to wholesale funding markets by end of January 2008; and
- carry out analysis of funding maturities and ascertain key dependencies by the end of December 2007. The supervision team was to continue its increased liquidity monitoring.

1352. At the outset of the SREP, securitisation was recorded as a priority area of focus during the review. However, the validation panel pack stated that: *'It has not been possible to assess the situation adequately in the present situation, given the volatility of markets and the pressure on qualified resources in the FSA.* [The FSA] *will be reviewing this issue on a thematic basis, but will not be able to come to any conclusions until 2008, in the absence of any activity in the market at present'.* No additional capital charge was applied for securitisation risk at this time, but the panel pack recorded that the FSA reserved its position until the outcome of the securitisation review was known. An RMP action was set for the FSA to carry out a review of securitisation risk by April 2008.

1353. The firm's disclosures about Treasury assets in its 27 February 2008 results presentation (see Part 2, Section 2.10.3, '*Market perceptions of HBOS in 2008'*) brought the quality of Treasury assets more firmly to the attention of the FSA.(243) The supervision team responded quickly by preparing a high-level analysis of the HBOS Alt-A holding. A briefing paper was prepared for Mr Strachan which outlined the exposures to debt securities on HBOS's balance sheet. This issue was also highlighted in a briefing to the FSA Chief Executive, Sir Hector, and Chairman, Sir Callum, on 9 April 2008: '*funding as the immediate risk facing the firm and the overhang of the ABS revaluation is as much an issue of market confidence as it is of regulatory capital per se. Adverse reaction to marking exposures to market could make the firm's funding and capital position more challenging'.*

1354. The team commissioned the FSA's Risk Specialist Division (RSD) to assess HBOS's valuations. In the resultant paper, dated 4 April 2008, RSD concluded that there was *'strong evidence that the firm had been slow to reflect current market pricing into its valuations'* and there may be '*systematic overstatement'* of valuations. RSD recommended a revaluation adjustment of a combined banking book and trading book of about £2.7 billion. HBOS subsequently announced a total fair value adjustment of £2.8 billion on 28 April 2008. In addition, the valuation of debt securities in illiquid market conditions was added to the RMP.

1355. Internal FSA briefings and email correspondence from March 2008 recorded the high risk of HBOS becoming illiquid in the short term. By this stage, detailed contingency planning work was being undertaken by the FSA, and the other Tripartite authorities in relation to HBOS. April 2008 also saw the creation of the Special Liquidity Scheme (SLS). The FSA issued the delayed ARROW letter on 22 April 2008. This set out that HBOS was '*one of the UK retail banks most reliant on the wholesale funding markets and it is imperative that the Group manages the balance sheet effectively so as to reduce this reliance*'. The letter stressed that the FSA would be

(243) Regulatory returns relating to liquidity assets were not sufficiently detailed to indicate investment in such assets.

maintaining close monitoring of the firm's funding plans to ensure that the *'funding assumptions remain realistic and that you are taking all the necessary actions to rigorously control asset growth, meet or exceed deposit plans; diversify and lengthen the liability profile and contingency arrangements are implemented where appropriate'*. As well as carrying forward the RMP actions that had been set following the SREP review, several additional actions for Treasury were included in the updated RMP that was sent to the firm alongside the ARROW letter.[244]

1356. As the financial crisis deepened, the close monitoring of HBOS's liquidity position and contingency planning work for HBOS became increasingly one and the same. Meetings with the firm were more frequent and FSA senior management played a significantly more prominent role. The contingency planning work carried out by the FSA in respect of HBOS is considered in more detail in Section 4.8.

(244) The Treasury RMP sought to address the valuation of debt securities, control and monitoring of branches, expansion of the CAD2 model and review of irregular trading in its Australian branch (misrepresentation of trades and exploitation of weaknesses in the pricing system by a trader in HBOS's Sydney branch).

4

4.6 Supervisory approach to capital and Basel II implementation

4.6.1 Introduction

1357. This section describes the FSA's supervisory approach to bank capital and, in particular, considers the supervisory work conducted on HBOS's capital position (Section 4.6.2). It also considers the implementation of Basel II (Section 4.6.3).

1358. The FSA's overall approach to the supervision of capital pre-crisis was inadequate in that it was too high-level and reactive. In that sense it reflected some inherent weaknesses in the Basel framework. The FSA did not collect adequate data to assess prudential risks and generally did not require banks to hold sufficient capital to cover an economic downturn.

1359. A significant part of the prevailing supervisory capital framework was effectively put on hold in 2006 and 2007, pending implementation of Basel II, which was perceived as the solution to weaknesses in the framework. Basel II took much longer to implement than expected. It was a complex and resource intensive process, both for the FSA and the firm, and the risk crystallised before that regime had time to bed down properly. No action had been taken in the interim to deal with HBOS's increasing risk profile.

4.6.2 Supervisory approach to capital

Framework for the supervision of capital and main areas of focus

1360. The general approach to the supervision of capital during the Review Period comprised the following:

- Handbook Rules and Guidance for firms to follow. These set out the minimum capital requirements that firms should meet. Prior to 1 January 2007, FSA rules were in line with the Basel I regime. From 1 January 2007, they reflected the Basel II regime.(245)

- Guidance on the level of capital the FSA expected a firm to hold above the minimum required by the Handbook. This was under the ICR regime whilst Basel I was in place; and the Pillar 2 regime following the introduction of Basel II.

- Half yearly reporting of Group consolidated capital position and quarterly reporting of the capital position of the individual banks within the Group. The reports were collected centrally and supervision teams would be alerted to any exceptions thrown up by the internal system checks, such as if the report showed less capital than the requirement. There was no requirement for a formal review of the returns by the supervision team. HBOS Group's reporting in the Review Period did not highlight any breaches of its capital position.

- C&C meetings to discuss capital issues.

(245) 2007 was a transitional year in which for some firms, including HBOS, substantial aspects of the new Basel II regime could be deferred until 1 January 2008.

- The lead associate on the supervision team would typically be responsible for capital, alongside other responsibilities, such as leading on Group issues.

1361. Other HBOS supervisory work of a capital nature prior to the financial crisis included:

- reviewing the firm's application to use models to calculate its market risk requirements in 2007;
- reviewing individual transactions impacting the firm's capital position for compliance with the Handbook. These were typically capital issuance, share buy-backs or securitisations(246) and would be prompted by HBOS approaching the supervision team when they wished to undertake such a transaction;
- reviewing the Group's approach to managing intra-group transactions and arrangements for compliance with the Handbook;
- reviewing the 'One Bank Project' for compliance with the capital requirements of FSMA Part VII (a transfer of business). This project was the Group's internal restructuring in 2007 to move the principal UK businesses onto a single balance sheet, being Bank of Scotland plc; and
- participating in cross firm thematic reviews by FSA risk specialists into stress-testing and their approach to interest-rate risk (both 2006).

1362. Following the onset of the crisis of the financial system in 2007, there was a significant step up in the focus and attention on capital and the Group's projected capital plans. For example, the FSA commenced its own sensitivity analysis of the Group's capital position, considering the potential impact of credit and liquidity issues on the firm; and requested that the firm provide on a monthly basis forward projections of its capital position.

1363. In April 2008, the FSA also introduced a capital regime for the major UK banks, including HBOS, which was more stringent than the prevailing Basel standards. Under this regime, firms were asked to meet a new 5% minimum Core Tier 1 requirement by 31 December 2008. The new regime sought to improve the quality and quantum of capital that firms held, such that they were more capable of absorbing the losses which were starting to emerge, and to promote confidence in the market. As the financial crisis evolved, only Core Tier 1 capital was perceived as capable of unambiguously absorbing losses to enable a bank to remain a going concern. Other Tier 1 and Tier 2 instruments, such as preference securities and subordinated debt, typically had a repayment obligation, while dividends and coupons continued to be paid.

1364. Supervisory work during 2008 in relation to HBOS's capital position, including the firm's £4 billion rights issue, is considered further in Section 4.8, *'Contingency planning'* (see Box 4.12).

Stress testing

1365. Until the implementation of Basel II, there was no explicit link between the amount of capital a firm held and the results of its stress testing. However, stress testing was required by global regulators as a key risk management tool prior to Basel II. In 2000, the Basel Committee on Banking Supervision's Principles for the Management of Credit Risk set out that: '*Banks should take into consideration potential future changes in economic conditions when assessing individual credits and their credit portfolios, and should assess their credit risk exposures under stressful conditions'*. Similarly, an FSA 'Dear CEO' letter to firms in 2006 emphasised that '*Stress testing and scenario analysis are essential tools for firms' planning and risk management processes*.'

(246) Banks can reduce their capital requirements by transferring assets and risks under a securitisation structure to third parties .

1366. However, stress testing has been an evolving process and the FSA had been pursuing improvements by UK firms for a number of years. Surveys in 2002 and 2003 found practice to be mixed. Following these surveys, the FSA developed a set of principles to create a framework of best practice, which was set out in a discussion paper in May 2005.[247] A further survey in 2006 used the framework as the standard against which to judge a number of firms, including HBOS. The results of this survey, which were communicated in a 'Dear CEO' letter in October 2006, found that only a small number of firms had practices that ranked strongly against the framework, but even then most firms were in the process of developing and improving practices. The FSA reiterated its belief in the framework as good practice along with the expectation that all firms, in particular the larger and more complex firms, move towards the principles. Similarly, the FSA's 2006 *Financial Risk Outlook* noted: '*We believe it is now more important than ever that firms analyse and test alternative assumptions, and that they invest appropriately in, and respond proactively to, effective stress testing of their key risks.*'

1367. HBOS was not one of the firms ranked strongly in the 2006 survey, having elements of both good and weak practice. Two particular weaknesses were a lack of articulation of a risk appetite within which to consider the implications of the stress testing results, and system and data issues impeding the ability of management to identify, quantify and manage the stresses. Through the Review Period an RMP action to improve stress testing existed in one guise or another.

1368. As part of the implementation of Basel II, the FSA required firms to have sufficient capital to be able to survive a severe but plausible downturn, as may be experienced once every 25 years. This created an explicit link between capital and stress testing (see Section 4.6.3 for comments on Basel implementation).

Weaknesses in the supervisory approach during the period

1369. There were a number of weaknesses in the prevailing approach to the supervision of capital during the Review Period, many of which were intended to be tackled by the Basel II regime. Fundamentally, the approach was not built on an understanding of firms' assets. The overall approach was also too high-level, insufficiently forward looking and too reliant on issues being raised by HBOS. For example:

- the FSA did not as a matter of course review in detail a firm's capital management framework or the underlying capital plans, projections and assumptions;
- the FSA did not conduct its own asset quality reviews, stress tests or sensitivity analysis; and
- regulatory reporting of a firm's capital position did not include forward-looking projections.

1370. Basel I set the minimum capital standards. The FSA then gave guidance on the further capital a bank should hold above the minimum using the ICR regime. It involved the FSA scoring a series of risks that it felt were not adequately captured in the Basel I minimum standard. These scores were then converted to a capital add-on. The capital add-on was a quantitative assessment, but based on judgement rather than analysis, and was made by reference to the add-ons given to the firm's peers and FSA experience. It was more a relative rather than absolute measure of risk.

1371. As noted previously, the ICR for HBOS was increased in January 2004 following an Interim ARROW assessment. This increase reflected a range of supervisory concerns, including growth contributing to an increased risk profile. The ICR was subsequently reduced back to 9% from

(247) DP 05/2: Stress testing. This did not constitute formal FSA guidance.

9.5% in December 2004 further to the actions and proposed actions by the firm to deal with the concerns.

1372. Despite a significant increase in the risk profile of the Group in the Review Period, the FSA did not change HBOS's ICR for a period of three years until it was superseded by Basel II and Individual Capital Guidance (ICG) on 1 January 2008.

1373. The Review did not find any evidence to suggest that the supervision team considered the need to review the ICR in the period from 2005 to 2007 in response to changes in HBOS's risk profile. In the apparently benign period before 2007, when banks were reporting strong and consistently increasing profits, and with high turnover on the supervision team resulting in a high proportion of inexperienced staff, there was a failure within the FSA to comprehend the change in the risk profile of HBOS and the capital implications.

1374. The ICR regime had effectively ceased to exist in a meaningful way. It had become a rarely used tool to incentivise behaviour and had generally become insensitive to changes in a firm's risk profile. This was not unique to HBOS. The implementation of Basel II goes some way to explaining why. The Pillar 2 regime of Basel II was intended to provide a more risk sensitive and systematic approach to assessing the level of capital a firm should hold.

1375. The FSA agreed to the Group's share buy-back programme in 2005 to 2007, which returned £2.5 billion of capital to shareholders, on the basis of the Group presenting a schedule showing its capital ratios remained above both the minimum and its target ratios without the need to raise additional capital. The supervision team did not review the reasonableness of the assumptions underpinning the presented capital schedule or consider what the position might be if the business environment worsened and the Group's profits suffered. However, the approach adopted by the supervision team was fully in accordance with the FSA policy, as set out in the Handbook.

1376. Implementation of the Basel II Pillar 2 regime took place in 2007 in readiness for new capital guidance to become effective on 1 January 2008 along with the rest of Basel II. The implementation of Basel II sought to deal with the first two points in paragraph 1373. However, within the Review Period, Basel II had not been fully implemented and detailed reviews were not completed. With the onset of the financial crisis in 2007, implementation of the new Pillar 2 regime was too late to have an impact.

1377. Following the onset of the financial crisis, from spring 2008 the FSA started to ask firms to report regularly on their forward capital projections. The FSA also started to undertake its own substantive stress testing of firms' positions and their resilience under stress.

4.6.3 Basel II implementation

1378. The Basel Committee on Banking Supervision (BCBS) published its initial Accord (Basel I) in 1988 setting out a regulatory capital framework for internationally active banks. In June 2004 the Committee published a revised and substantially amended accord (Basel II).

1379. The objective of Basel II was to develop a framework that would strengthen the soundness and stability of the international banking system. In particular, it was seeking to correct identified weaknesses in the regime:

- It was insufficiently sensitive to the different risks that banks were running. So, for example, a loan to an AAA-rated counterparty would attract a similar treatment to a BBB-rated counterparty. This gave firms such as HBOS,that typically targeted more lowly rated counterparties, an inappropriate capital advantage.

- It did not capture the full range of risks to which banks were exposed (e.g. interest rate risk in the banking book or credit concentration risk).

1380. However, Basel II did not improve the quality of capital that firms must hold, so a firm's capital requirements could theoretically still be met with as little as 25% of core equity. This was a weakness of Basel I carried over to Basel II.(248) In addition, there was no intent to increase the overall level of capital in the system. This was also a stated objective of the FSA in respect of the UK banking system. The FSA also committed '*to ensuring UK implementation did not disadvantage UK firms in comparison with competitors in other parts of the world*'.

1381. Basel II introduced three pillars:

- *Pillar 1: the minimum capital that a firm should hold*. The standard remained that firms should hold regulatory capital resources of at least 8% of their risk weighted assets (RWAs). As with the previous regime this covered credit risk and market risk, but also introduced a new requirement for operational risk. Basel II also introduced greater risk sensitivity to the standard capital calculations, while allowing more advanced banks to calculate their credit and operational risk capital requirements using their own internal methodologies. These were the IRB approach for credit risk and Advanced Measurement Approach (AMA) for operational risk. To use their own methodologies firms needed to meet certain risk management standards and receive the approval of their regulators that their methodologies were appropriate. The FSA formally approved models by granting waivers under section 148 of FSMA.(249)

- *Pillar 2: to improve risk management and determine the amount of capital banks should hold above the minimum to cover other risks.* This comprised two parts: a firm's own assessment of its risks and the amount of capital its business needed (the ICAAP);(250) and the firm's regulator forming its view (the SREP).(251) The assessment was to cover all risks faced by the business not covered within Pillar 1 – so, for example, in the UK this typically included concentration risk, non-trading interest rate risk, pension risk and the ability to survive a severe but plausible downturn (i.e. capital planning and stress test). Unlike Pillar 1, there were no prescribed methodologies for calculating these requirements. It was left to firms and national regulators to develop their own approaches.

- *Pillar 3:* enhanced disclosure of a firm's capital position to improve market discipline.

1382. The FSA's Pillar 1 assessments for credit risk models were not akin to what might be called a conventional credit risk review. While there was some overlap, the Pillar 1 reviews had a much narrower remit. The reviews focused on whether the bank could build and validate models to measure the key inputs into the capital calculation, 'probability of default' and 'loss given default'. They were not a comprehensive assessment of the overall credit environment, or the sanctioning and monitoring processes. Moreover, they did not consider other typical asset quality measures such as loan-to-value (LTV) profiles or arrears emergence data series. An FSA credit risk specialist commented in interview that: *'essentially we were not looking for the traditional risk measures; that would be a key difference between IRB and a normal credit risk review'*. The Pillar 1 reviews did not really focus on the present and future state of a bank's loan book as building a capital calculation model relied on the use of historic data. Nor did they involve looking at individual case files as might be the case in a normal credit review. In general,

(248) There was a longer term intent by the Basel Committee to review the eligibility of capital instruments, but this was not due until after Basel II was implemented.
(249) More detail on the Basel II waiver process can be found in *Appendix 2F, FSA policy on IRB model approvals during the Review Period* within *The RBS Report*.
(250) Internal Capital Adequacy Assessment Process.
(251) Supervisory Review and Evaluation Process.

the reviews were limited in the understanding they provided of the prevailing and emerging credit risk profile of a firm.

1383. As set out in the BCBS's Principles for the Management of Credit Risk: *'Concentrations are probably the single most important cause of major credit problems'*. While in principle types of concentrations (e.g. a significant exposure to commercial property) can be identified, there is an inherent difficulty in assessing how much capital should be held for the risk. In a time of stress or economic downturn, assumptions about the behaviour of portfolios tend to break down, with exposures becoming correlated in ways previously unforeseen. This means that the capital assessment can be complex and the ability to use historic data is severely limited. For this reason, the assessment of a concentration risk capital add-on, as part of Pillar 2, by necessity involves a degree of judgement. After a prolonged benign economic period, a natural bias exists towards assessing the risk on the low side, and so under-estimating its potential seriousness.

1384. The FSA recognised that Basel II implementation would be a challenge for both firms and the FSA in its early years. As such, the FSA indicated that it would take a pragmatic approach to implementation, although this did not mean that the FSA would accept standards that were lower than those set out in the Handbook.

Table 4.5: Comparison of HBOS's Basel I and Basel II measures as at December 2007

	Basel I	Basel II
Tier 1 capital resources (£ billion)	24.4	23.8[11]
Total capital resources (£ billion)	36.7	33.9
Risk Weighted Assets (RWAs, £ billion)	330.8	309.2
Tier 1 ratio	7.4%	7.7%
Total capital ratio	11.1%	11.0%
FSA Capital guidance (ICR/ICG, %)	9%	8.7%[12]
Minimum capital requirement (8% of RWAs, £ billion)	26.5	24.7
Surplus over minimum requirement (£ billion)	10.2	9.2
FSA guidance (ICR/ICG, £ billion)	29.8	26.8
Surplus over guidance (£ billion)	6.9	7.1

1385. As shown in Table 4.5, there was little overall quantitative effect from HBOS moving to Basel II as at 31 December 2007. The Group's surplus over the minimum requirement fell by £1 billion. This suggests that the Basel II Pillar 1 methodologies captured HBOS's changed risk profile better than Basel I. However, the new Pillar 2 assessment resulted in different, and lower, add-ons than had been the case under the previous regime (see Table 4.6). The surplus was more than offset by a £1.3 billion reduction in the additional Pillar 2 element.

Table 4.6: Comparison of HBOS's ICR and ICG Pillar 2 add-ons at 31 December 2007

	ICR (£ billion)	ICG (£ billion)
Non-trading interest rate risk; liability risks; and legal, operational and other business risks	2.5	
Concentration risk	0.8	0.8
Stress testing scenario		0.5
Pension obligation risk		0.7
Other/rounding	0.1	0.1
TOTAL ADD-ON	3.4	2.1

1386. Although HBOS's surplus over minimum (Pillar 1) requirements changed by only £1 billion, there were some significant differences between Basel I and Basel II; these are estimated in Table 4.7. The Group experienced a significant reduction in retail capital requirements as the mortgage risk weights calculated using its models fell to around 15% from 50% under Basel I. This capital reduction was offset by increased risk weights on modelled corporate exposures (an average of 119%) and equity holdings (an average of 256%, which would have been 100% under Basel I), and a change in the measurement of exposures to include estimates of further amounts that could be drawn down by the borrower. There was also a separate capital requirement for operational risk (£15 billion of RWAs) and some new deductions from capital, notably if the firm's expected credit losses exceeded the accounting provisions made.

Table 4.7: Estimated changes in HBOS's surplus over minimum capital requirements at 31 December 2007

	£bn
Surplus over minimum requirements – Basel 1 basis	**10.2**
Changes in the definition of capital resources:	
– Deduction of expected credit losses	(4.0)
– Other changes in capital resources	1.2
Changes in average risk weights using internal models:	
– Retail mortgages	5.8
– Corporate exposures	(1.2)
– Equities	(0.3)
Changes in the measurement basis for credit exposures	(0.9)
New operational risk charge	(1.2)
Other changes in capital requirements	(0.4)
Surplus over minimum requirements – Basel 2 basis	**9.2**

1387. The IRB approval covered approximately 77% of the Group's credit risk exposures as at December 2007. However, the story was very different for the individual divisions. Substantially, all of Retail's credit exposures, covering mortgages, credit cards and unsecured lending, were covered by IRB, whereas for Corporate, only around 40% were covered.

1388. Credit risk exposures not on IRB moved to the standardised approach with the exception of the Australian exposures which went on to a modified Basel I treatment as permitted by the FSA Handbook at the time, but under a waiver process. The DMC that agreed the treatment originally required a 25% uplift to the Basel I capital requirement whereas the firm had proposed 5%. However, this was subsequently amended by the DMC to a 10% uplift following challenge from the firm about what it considered to be a '*wholly unacceptable situation*'. The 10% uplift was approximately a further £300m capital requirement. Given the losses the business subsequently incurred, even a 25% uplift would have proved too little.

1389. In October 2007, there was a general plea by the firm for the FSA to be aware that its approach to IRB was putting downward pressure on reported Tier 1 capital ratios. The Group claimed that this was damaging confidence in UK banks, was putting them at a disadvantage with international competitors, and that the lack of difference between the IRB and standardised approaches, in particular within Corporate, was damaging the credibility of Basel II. On this last point, the Group appears to have been under a misapprehension that the advanced approaches should generally deliver a lower capital requirement than the standardised approaches. This was not the case. Basel II did not include an assumption that the standardised risk weights should generally be higher than under an IRB approach.

1390. In late 2007, amid wider concerns that the implementation of Basel II would have a detrimental impact on the capital ratios of the larger UK banks generally, the UK banking industry lobbied the FSA for modifications to certain exposures. Two such issues were the treatment of venture capital investments and the tax treatment on expected loss. The FSA clarified the approach to be taken in December 2007. (252) The impact of both was beneficial to HBOS. The December

(252) Under Basel III, the treatment of venture capital investments would be permissible. Tax treatment on expected loss will no longer be permissible.

2007 Board management information reported improvements in the Basel II Tier 1 ratio of seven basis points and 17 basis points respectively for venture capital investments and the tax treatment on expected loss: the combined effect was estimated as a Tier 1 capital saving of about £800 million.

Implementation of Pillar 1

1391. HBOS elected to implement the IRB and AMA methodologies for credit risk exposures and operational risk, respectively. The capital benefit expected by the Group did not substantively materialise on 1 January 2008, as illustrated in Table 4.5. This was because a number of the corporate models were not approved by the FSA and those that were approved did not generate the expected reduction in risk weights. Nevertheless, the Group still expected a longer term reduction in its capital requirements by getting model approval for more portfolios and from changes to the approved models to remove what it regarded as excessive conservatism imposed by the FSA.

4

1392. Given the size of task that Basel II model recognition across the whole of the sector represented and the limited resources available to achieve it, the FSA had to prioritise. It did so by:

- focusing its work on those of a firm's models that were due to be implemented at the start of the new regime and covered the largest portfolios (defined by exposure value); and

- extrapolating from those models that were reviewed to others that were adaptations, or were built using similar data and principles.

1393. In the case of HBOS, the FSA focused on the IRB models for prime retail mortgages, personal loans, credit cards, commercial property, corporates and banks. In aggregate, these models covered about £307 billion of exposures. The FSA also focused on key themes such as senior management understanding, how models were used in practice, stress testing and independent model valuation. Various models for specialised mortgage lending, such as buy-to-let, self-certification or sub-prime, were not subject to a specific review on the grounds that these exposures were relatively small in absolute terms (in aggregate about £62 billion).

1394. In respect of the International Division, APRA shared information about its reviews of the material Australian models with the FSA and IFSRA undertook a review of the Irish mortgage model which the FSA took into account.

1395. Not all IRB approaches adopted by HBOS were based on internal models. The Group used an approach where judgements on ratings were taken by HBOS within a prescribed regulatory framework for certain securitisation investments with an exposure value of £5.9 billion at the end of 2008, and applied risk weights specified by the regulators to £2.7 billion of equity exposures. Most significantly, the calculations for specialised property lending (notably the Irish property development portfolio) used the so-called 'slotting' approach, under which exposures are allocated a risk weight specified by the regulator according to the bank's judgement as to whether the credit quality is strong, good, satisfactory or weak, where good broadly maps to an external BB rating. In August 2008, 87% of the Irish property development book was classed as good or better, with only 2% considered weak (this was a deterioration from April 2008 when 95% was classed as good or better).

1396. Minutes of the planning DMC, which agreed the scope of the FSA review, indicated that supervision was *'proposing to only undertake desk based reviews of specialised areas'*. However, this Review has not found evidence to determine the extent of any analysis undertaken by the supervision team.

1397. FSA visits by its risk specialists to review the models started in earnest in 2004 and continued throughout the Review Period. There were fourteen detailed visits by technical specialists over the four years from 2004 – roughly one visit a year for each material model. Alongside visits by specialists, the supervision team had monthly catch-up calls to monitor the delivery of the firm's Basel programme, and Basel II implementation was a regular agenda item in meetings with the Group risk function and the divisions.

1398. IRB model development was a difficult process in Corporate and the division was *'behind the curve'* on implementation. Following a review of the Property model in 2005 and FSA concerns with data, HBOS identified substantive issues with the other models, and so moved the Corporate programme to 'red'. In early 2006, Corporate conducted a 100 day turn around project. This involved significant extra firm resource being devoted to the project in early 2006, and contributed to a six month delay to the Group's timetable for submitting an application to the FSA to use advanced models.

1399. Following IRB reviews of the property and general corporate models (GCM) in August and September 2006, the FSA still had concerns. It wrote to HBOS that: '*the* [Commercial Property Investment] *model does not meet the standards for AIRB compliance and we are not confident it will meet these standards unless key issues are addressed … there remain several fundamental issues with the model, and the project processes that surround it*'; and: '*At this stage we do not have the evidence that the GCM model suite will meet the standards for IRB compliance … we still have major concerns surrounding model development, which appear more fundamental than model technicalities*'.

1400. The firm's application was submitted in December 2006. Of the 70 models within its IRB program, 40 were identified for first use on 1 January 2008 covering about £402 billion of credit exposures.

1401. In March 2007, the FSA risk specialists noted improvements to the general corporate model following substantial resource and time being devoted to it by the firm, but still had concerns. In April 2007, the FSA risk specialists recommended that use of the property model be deferred as the firm had effectively developed a new model that had yet to be implemented or validated internally.

1402. HBOS received approval in May 2007 to use the AMA approach for operational risk. No conditions were attached, which suggests regulatory confidence in the firm's approach to operational risk management.

1403. As noted previously, FSA decisions on whether to approve a firm's waiver application to use the IRB approach for credit risk under Basel II were made by a DMC which involved FSA senior management. The committee drew its membership from supervision and the FSA's specialist Risk Review Department, together with representatives from the FSA's Policy, Permissions and General Counsel Divisions. In line with FSA policy, DMC panel meetings at which HBOS's application was discussed were chaired by a supervisory Head of Department who was independent from the supervision team.

1404. The DMC met twice in June 2007 to consider HBOS's application for approval to use the IRB approach. The DMC overturned the presenting team's proposal that HBOS's application be *'accepted with conditions'* by unanimously voting for a 'minded to grant' decision. Despite the language used, this was actually a decision that the FSA could not approve the models at that stage and that more work was required by the Corporate Division to demonstrate compliance with the IRB standards and the requirements of the FSA's Prudential Sourcebook (BIPRU). Nevertheless, the FSA considered it likely that upon completion of specified actions the firm would be able to meet minimum standards and the models could be approved at a future DMC.

Practically, it also meant that the FSA kept the waiver application 'live' so the firm would not have to re-submit, as would have been the case with an outright rejection.

1405. Further to the FSA's 'minded to grant' decision, Lord Stevenson wrote to the FSA Chairman, Sir Callum, to protest the decision and argue that it would have severe reputational consequences. This resulted in an internal FSA review of the DMC process, the outcome of which was a letter back to the firm which stated that the FSA had followed due process: *'We are fully satisfied that the decision was taken entirely properly'*. The letter also set out that the FSA would be prepared to review the firm's application when it felt in a position to demonstrate progress on the concerns raised.

1406. Between June 2007 and September 2007, the firm undertook further work to deal with the FSA's concerns with the corporate models. The DMC reviewed HBOS's work plan on 1 August 2007. At a further DMC meeting on 10 September 2007, the panel decided to approve the models but with conditions that further work was still necessary before the firm could use the models from 1 January 2008. This included imposing various floors on certain parameters in the model. The firm estimated that the impact of the FSA requirements was to increase the RWAs by £5.9 billion or 11.7%. In internal documents, the firm expressed concern that the FSA typically required prudence for every individual parameter within the models, rather than looking at the portfolios in the round (i.e. allowing some off-setting in the model).

1407. As at 31 December 2007, the FSA had not completed a substantive review of whether the firm had met the necessary conditions. This was reflected in a letter from the supervision team: '*indicatively we think the work has been completed. However, we are relying on your own assurance as well as our initial high level review, which is based on documentation received and discussions … We have not carried out a full review, and so will not confirm the conditions have been met … We will carry out a full review in line with model review in 2008'*. Of the major UK banks, HBOS was one of the last to be given IRB approval due to the weaknesses in its corporate model. It was not unusual for decisions to have conditions attached. However, HBOS was an outlier amongst the major UK banks to be given a 'minded to grant' decision.

1408. Supervision did not at the time see the data and modelling issues as indicative of wider failings in the risk management and governance processes. The perception of the data issues by the FSA would have been most obviously visible in the context of Corporate, rather than the wider Group. As noted in Section 4.7.3, *'Evolution of management, governance, culture and controls risk probability scores for HBOS'*, there was not a view that the firm's overall control framework was poor. Data issues were an inherent industry-wide challenge in modelling corporate exposures and this may have distracted from more firm-specific matters.

1409. The corporate models significantly under-estimated risk, as revealed by the financial crisis. The alternative to granting approval would have been that the firm remained on the standardised approach. From a capital perspective, this may not have delivered a higher capital charge overall. The majority of its exposures were unrated and would have defaulted to a 100% risk weight, which was lower on average than that delivered by the corporate IRB models. It is unclear whether the FSA would have been in a better position to argue for a higher ICR or Pillar 2 add-on if the standardised approach had been used. The other issue had non-approval been pursued would have been whether it damaged confidence in the firm at a particularly sensitive time. The FSA's approach attempted to get the firm to a minimum standard, for example by imposing restrictions to deal with model weaknesses, and to work with the firm to further strengthen the models over time. The approach taken by the FSA was not unique to HBOS but it does seem to have been flawed. Model weaknesses may have contributed to under-estimates of capital requirements, both in forward-looking stress tests and as asset quality began to deteriorate during the financial crisis.

1410. Basel II demanded a lot of resource and time which could have helpfully been spent on other matters. However, it is not certain that the FSA would have recruited the additional technical resource at all had it not been needed to review IRB models.

Implementation of Pillar 2

1411. To initiate the process to determine its Pillar 2 capital requirement, HBOS submitted its first ICAAP document to the FSA in early 2007.[253] As a document, this was regarded at the time as one of the better ICAAP submissions, covering everything that the FSA expected to see.

1412. The FSA undertook its first SREP of HBOS in late summer 2007. The conclusions were formally agreed by an FSA panel in November 2007, at which time the firm was given an ICG capital requirement to replace the existing ICR.

Box 4.8: Conduct of the Supervisory Review and Evaluation Process (SREP)

The 2007 SREP was the first for HBOS and it was also one of the very first SREPs to be conducted by the FSA. It was therefore embryonic – in many ways the FSA was still developing its approaches and was learning how best to conduct reviews and what were the appropriate standards against which to judge firms. The SREP also suffered from a lack of resources. At this time, the FSA was implementing the Pillar 1 methodologies, the financial crisis was emerging and, specific to HBOS, an ARROW review had been started and there was a transitional period between managers of the HBOS supervision team. These issues adversely affected the SREP in a number of ways:

1. First, the approach was one of assessment of certain individual risks. There was no overall holistic assessment of the Group and how the risks might interact.

2. Second, where possible, pragmatic decisions were taken to utilise other processes and thematic reviews and so the SREP involved little detailed original review work. For example, a 2006 thematic exercise on interest rate risk was used to support the conclusions for assessing interest rate risk in the firm's banking book, while the governance component of the SREP was deferred until the ARROW in late 2007 and early 2008, with ICG to be updated for any findings from the later review.

3. Third, it was the FSA approach at the time not to review separately credit risk as part of a SREP where a firm was pursuing a waiver application to use its own models for its Pillar 1 credit risk requirement. On the face of it this was a reasonable approach to take, given the resources devoted to reviewing models and the requirement that the substantial part of the portfolio's credit risk should be covered by a firm's IRB models[254]. At the final FSA review panel, £125 billion of HBOS's exposures (primarily property related in the Corporate and International Division) were still on the Standardised Approach due to FSA concerns with the relevant models.[255] There was no consideration of whether the Standardised Approach was adequate to capture the risks in these portfolios, but the intention was for further IRB work to be done in 2008 to deal with these concerns. The issues with the models were not resolved.

(253) Three documents in total were submitted: before Board sign-off in April 2007; post Board sign-off in May 2007 and with an updated capital plan in September 2007.
(254) The FSA required a firm with permission to use the IRB approach to ultimately (i.e. after roll-out) have at least 85% of its risk covered by IRB methodologies. This was to stop firms cherry picking the IRB or standardised approaches for different asset types that would lead to the lowest capital outcome.
(255) The £125 billion is derived from £137 billion per Basel II report less an estimate (£12 billion) by the Review team for exposures permanently excluded from IRB.

4. Fourth, the approach to concentration risk was driven by the 'FSA concentration risk matrix'. This was a simple tool that scored the firm against various forms of concentration and suggested an appropriate additional capital requirement.(256) The review identified the key concentrations noted in the asset quality section (commercial property and single names), yet application of the matrix only suggested additional capital for the UK-centric nature of HBOS's exposures: neither CRE nor individual large exposures triggered an add-on. The panel did require additional capital for CRE, but nothing was added for HBOS's individual large exposures. The total concentration risk additional capital requirement was £0.8 billion. This figure did not differ greatly from the last time this was calculated at the end of 2003, even given the increase in concentration risk. At end June 2007, the largest individual Corporate exposure was £2.3 billion, there were ten exposures greater than £1 billion, and the top 30 exposures totalled £32 billion. This meant it would only take one default of a large exposure (with a 50% loss) to erode the additional capital held for concentration risk. The matrix delivered an inadequate result for HBOS. This was viewed by the FSA as an embryonic tool at the time, intended as a temporary measure pending further work.

5. Fifth, capital planning focused on the nature and severity of the stressed scenario and whether it matched the FSA standard.(257) As with most firms, the FSA did not consider the scenario developed by HBOS to be sufficiently severe and so imposed an additional £500 million capital requirement with an RMP action on the firm to submit a revised stress-test. The other significant RMP action was to review the management actions the firm claimed it would undertake in a stress. This was the more important area to review, in particular as it affected Corporate Division. The corporate model involved a significant degree of judgement, so, whatever the nature of the scenario, the inbuilt bias towards previous experience and personal prejudice would be difficult to overcome. In retrospect, the FSA missed an opportunity to explore the credibility and realism of the firm's actions before it needed to deploy them. By the time of the SREP panel, the firm was already deploying its management actions and was discovering that they were harder to implement than envisaged. This suggests the firm's internal review of its ICAAP had not been rigorous enough.(258)

6. Sixth, the FSA had intended to review HBOS's securitisation risks as part of a wider thematic review but specialist resource was diverted elsewhere and this did not take place. Instead the FSA recorded as an RMP action that its specialists would *'carry out an assessment of securitisation policies and practices within HBOS'* by April 2008.

7. Finally, reliance was placed on management's own review of the ICAAP, in line with the prevailing FSA view.

1413. The overall ICG given to HBOS was 103.6% of its Pillar 1 requirement plus £1.2 billion.(259) Expressed in equivalent terms to the previous ICR, this was a capital requirement of 8.7% and little changed to the 9% requirement last set in December 2004 despite the increase in the risk profile of the firm. At the time of the panel, the ICG equated to £24.3 billion, £2 billion more than the Pillar 1 requirement and £4.2 billion more than the Group felt it needed. By way of comparison, HBOS's ICG was relatively lower than the interim ICG set for RBS of 110% of its Pillar 1 requirement plus £1.7 billion.

1414. The proposed ICG was communicated to the firm on 30 October 2007,(260) prompting challenge by the firm on certain FSA methodologies.

(256) Whether a firm was UK centric, its regional distribution of mortgages, its sectoral mix, whether it had a large individual exposures.
(257) A severe but plausible economic downturn as might be experienced once every 25 years.
(258) The ability to turn off lending did not happen due to the pipeline and paralysis caused by the fear of loss of confidence.
(259) The requirement was to be met by total capital in accordance with the prevailing policy rather than the better quality Tier 1 or core equity.
(260) It was FSA policy to present the proposed ICG to the firm before going to the final panel. This was to give the firm the opportunity to correct any factual errors, and so that the final panel could be informed of the firm's reaction.

1415. The final ICG for HBOS was unchanged and communicated to the firm on 21 December 2007, along with RMP actions in respect of securitisations, concentration risk, liquidity stress testing and business planning (including capital planning and management actions). The RMP points turned out to be justified, yet at the time there was no great sense of urgency: the liquidity stress was to be submitted by April 2008 and the revised business plans by June 2008.

Implementation of Pillar 3

1416. The first public Pillar 3 disclosures were made as at the year ended 31 December 2008. This is outside of the Review Period so has not been considered as part of this Review. It is, however, worth noting that Pillar 3 would have increased transparency of the risk profile of HBOS's lending. The analysis in Part 2, Section 2.4.4, *'Higher-risk speculative lending',* is based on the 2008 Pillar 3 disclosures and indicates that the profile of HBOS's corporate lending was more skewed than peers towards higher risk assets. Analysis by the firm in September 2008, comparing itself with Barclays, came to a similar conclusion.

4.7 Supervisory approach to management, governance, culture and control functions

4.7.1 Introduction

1417. As set out in Part 3, the ineffectiveness of HBOS's management, governance, culture and controls was a key factor in the failure of the firm. This section considers whether the supervision team identified and then sought to address these failings.

1418. This section covers:

- the FSA's approach to assessing the effectiveness of management, governance, culture and controls (Section 4.7.2);
- evolution of management, governance, culture and controls risk probability scores for HBOS (Section 4.7.3);
- the supervision of Group oversight of controls (Section 4.7.4);
- assessment of the degree of reliance that could be placed on HBOS senior management (Section 4.7.5); and
- assessment of board effectiveness (Section 4.7.6).

4.7.2 The FSA's approach to assessing the effectiveness of management, governance, culture and controls

1419. As described earlier in this Report, prior to the financial crisis, the FSA's overall approach involved placing reliance, wherever possible, on a firm's senior management to ensure that risks were well controlled. The objective of supervisory work in this area was therefore to assess whether the management, governance, culture and control functions of a firm were effective and proportionate to the scale and complexity of the business.

1420. The degree of intensity applied to the supervision of management, governance, culture and controls issues during the Review Period was less than is now considered appropriate. Although the ARROW framework included an explicit focus on management, governance, culture and controls, views on these issues were principally taken at the supervision team level and were largely informed by C&C meetings and desk-based reviews of management information. While FSA specialists were able to undertake reviews of management, governance, culture and controls issues if a supervision team identified a specific concern, there was only a limited, unstructured framework during the Review Period to support supervisors in making such judgements. For example:

- there was insufficient involvement of FSA senior management in the day-to-day supervision of firms prior to the financial crisis to help influence the firm's senior management or to sense check and verify the commitments of the firm to follow through on plans;
- reviews of board effectiveness were only recommended good practice, not the norm;
- there was no mechanism to assess on an ongoing basis the competency and experience of approved persons; and
- a group risk appetite statement was a developing concept prior to 2007.

Consequently, there was insufficient analysis undertaken unless specific causes for concern existed.

1421. The nature and quality of the regulatory relationship with firms was a key component in forming supervisory judgements about management, governance and culture. There was some consideration of culture in a general sense in the conduct work to assess the implementation of the TCF initiative. Specifically in the case of HBOS, for example, culture was also considered as part of a 2004 Sales Culture Review, which was prompted by the FSA due to concerns about the control environment and selling practices in Retail.

4.7.3 Evolution of management, governance, culture and controls risk probability scores for HBOS

1422. The transition to the ARROW II process in 2006 introduced a new, more granular risk data management system (IRM) which allowed the FSA to produce risk probability scores and track them over time. Prior to the introduction of this system, there was no way of consistently measuring data. The elements considered by the FSA when establishing the risk score for the management, governance, culture and controls components of the overall risk probability matrix are set out in Table 4.8. The evolution of the management, governance, culture and controls scores for HBOS from mid-2006 is set out in Table 4.9.

Table 4.8: Risks addressed in the supervisory framework for management, governance, culture and controls

Oversight and governance	Risk group	Risk element
	Management, governance and culture	Culture and management
		Corporate governance
		Relationship with regulators
		Strategic planning
		Relationship with rest of Group
		Quality of ICAAP
	Control functions	Compliance monitoring and guidance
		Internal audit
		Enterprise-wide risk management

Table 4.9: HBOS ARROW risk probability scores for management, governance, culture and controls(a)

	October 2006	October 2007	April 2008	August 2008[b]
Overall risk score for HBOS	Medium High (MH)	High (H-)	High (H-)	High (H)
Combined oversight and governance score (management, governance, culture and controls)	Medium High (MH-)	Medium High (MH-)	Medium Low (ML)	Medium High (MH-)
Management, governance and culture	Medium High (MH-)	Medium Low (ML+)	Medium Low (ML)	Medium High (MH-)
Control functions	Medium High (MH-)	Medium High (MH)	Medium Low (ML+)	Medium High (MH-)

(a) Within the IRM system, '+' and '–' were used for aggregation purposes, but reporting to the firm was in whole letters.
(b) The Review was unable to find a record of why the IRM probability scores for HBOS were increased in July 2008, although the deteriorating market conditions are likely to have been a factor.

1423. As noted previously, there was an increase in the overall assessment of risk at the firm during this period, largely due to the escalation of environmental risks from autumn 2007. The combined management, governance, culture and controls score, which was one component making up the overall risk probability score, fell from Medium High in October 2006 to Medium Low by April 2008. The combined management, governance, culture and controls score subsequently returned to Medium High in July 2008, at the same time as HBOS's overall risk probability score was increased to the highest level.

1424. The management, governance and culture component was scored fairly neutrally as Medium Low for a large proportion of the Review Period. Under the FSA's risk-based approach, a Medium Low score equated to no need for further action. There were, however, some exceptions when management, governance and culture was scored as Medium High. In October 2006, the FSA was still transitioning to the new ARROW II process so the Medium High scoring for management, governance and culture was based on a partial view of the divisions. The score for management, governance and culture was also increased to Medium High in July 2008. While it is not clear what the exact trigger was for this increase, it coincided with an increase in HBOS's overall risk score to the highest level.

1425. The Medium High scores for HBOS's control functions in October 2006 and October 2007 were based on specific concerns about risk management in the areas of Basel II implementation, a cost reduction initiative by HBOS and financial systems and controls within the Insurance Division. By April 2008, these issues had been closed on IRM and HBOS's control functions were scored neutrally as Medium Low. The score was increased again to Medium High in July 2008.

1426. Overall, the relatively neutral probability scores, particularly during the middle of the Review Period, suggest that the supervision team did not have any significant causes for concern in this area and that it failed to pick up on the significant management, governance and culture failings set out in Part 3. This would have affected the pace and intensity with which the team focused on management, governance, culture and controls issues. It would also have informed the judgements taken on the degree of reliance that could be placed on the firm's senior management and control functions.

4.7.4 Supervision of Group oversight of controls

Context prior to the Review Period

1427. As set out previously, HBOS operated a federal approach to risk management, using a 'three lines of defence' model. Under this model, the first line of defence was devolved to the individual operating divisions, with divisional risk teams reporting to the business head rather than to the central Group Risk function. The second line of defence was provided by Group Risk and the third line of defence was provided by Group Internal Audit.

1428. The focus of supervisory attention following the merger between BoS and Halifax in 2001, in the absence of crystallised risk, was on ensuring the effective integration of two major banking businesses. By early 2004, the FSA expressed fundamental concerns about the effectiveness of HBOS's federal-style risk management framework. An RMP action was set in January 2004 to ensure that '*HBOS had a strong Group Risk function that provides challenge to and oversight of all business divisions*'. A Skilled Persons Report was commissioned from PwC to provide an independent review of the effectiveness of HBOS's risk management framework (see Box 4.9) and the FSA also increased HBOS's ICR from 9.0% to 9.5%.

1429. The use of both of these supervisory tools would have communicated a strong message to HBOS about the adequacy of its control framework. It was described in a letter to the firm from Mr Page, MRGD Director, as *'clearly a significant action for us to take'*. Mr Page subsequently met Mr Crosby on 21 January 2004 to discuss the ARROW assessment. A note of this meeting recorded that Mr Page *'stressed very strongly that HBOS was an outlier'* and that *'the controls were not adequate and behind the industry'*. Mr Page also stressed that Lord Stevenson and Mr Crosby *'had to give a stronger message of the need to balance controls and growth and also to ensure that group controls were adequate'*.

1430. At a time when supervision staff were told not to get into a position of being shadow directors, the issues raised as part of the January 2004 ARROW letter were a rare example of the FSA challenging HBOS's business strategy. These strong messages were driven by the Director of the supervision division and so provide an example of the difference that can be made with the support and greater involvement of senior management in supervision.

Box 4.9: Summary of the scope and main findings of PwC's Skilled Persons Report

The scope of PwC's Skilled Persons review was to assess the adequacy and appropriateness of the policies, procedures, methodologies, systems and controls relating to risk management at HBOS, as at 30 April 2004. PwC was also asked to reach a conclusion on the extent to which the risk management framework had been fully and consistently implemented, was robust, was fit for purpose and was working in practice.

In undertaking its review, PwC:

- reviewed the high-level frameworks for risk within the Group functions and the Business Divisions as well as the local arrangements within the Corporate, Retail, Treasury and Insurance Divisions;
- interviewed 63 people, including members of the Board and key individuals within Group functions and the operating divisions;
- observed meetings of the Audit Committee, the Risk Control Committees in Treasury and the Insurance Division and Group Risk Committees for Credit, Asset & Liability, Insurance & Investment Risk and Operational & Regulatory Risk; and
- reviewed extensive documentation including policy documents, committee meeting minutes, reports, management information, CVs, departmental structure charts, business plans, strategy documents and risk appetite statements.

Overall, the combination of documents reviewed, the individuals interviewed and committee meetings observed was comprehensive to meet the Requirement Notice set by the FSA.

As the review required an assessment of whether risk management policies, procedures and methodologies were working in practice, it is reasonable to expect the work to have included some form of testing (for example, a detailed assessment of the identification and quantification of a sample of specific risks within the business). The report is silent as to whether PwC performed testing of this nature; however, we note that this was not stipulated as an expectation or requirement by the FSA.

Structure and conclusions of the report

Due to the size and nature of HBOS, a comprehensive review of risk management across the Group was necessarily wide-ranging and complex.

The PwC report was structured in such a way as to provide overall high-level conclusions, some relevant background factual information as well as significant detailed commentary in relation to the group functions and the key areas of risk. Its recommendations were made throughout the document but were also summarised in a consolidated list.

The main conclusions reached were as follows:

- The risk management framework was conceptually well defined and well communicated.
- HBOS's federal structure would only be effective if the group oversight function operated in a rigorous and challenging way. In relation to Group Finance and Operational Risk, PwC found this to be the case but considered that a recent restructure and appointment of a new head (Mr Moore) meant that it was too early to draw conclusions.
- Whilst there was evidence of challenge between Group and the business divisions, this typically occurred outside the formal committee structures.
- In some areas (in particular the Insurance Division), the risk management processes and structures were still evolving at the time of review. However, management recognised that, in common with the rest of the industry, there was still some way to go before risk management structures could be said to be complete.
- The evolving regulatory framework, in particular Basel II, would lead to the development of more sophisticated risk management systems. As such, a number of improvements to risk management systems would be inextricably linked to the project timetable.
- There was a high level of engagement in risk management issues from the Board and throughout the Group. The involvement of non-executive directors (NEDs) on the risk control committees and the membership of business executives on risk committees had increased the profile of risk management throughout the Group.
- In general, the people involved in risk functions, particularly at Group level, were experienced and knowledgeable.
- PwC found that there was a need to codify and formalise a number of processes and practices that had evolved since the merger. There was also a need to make improvements in some specific areas where the Group fell short of best practice. However, taken as a whole, the Report stated that this did not constitute a fundamental restructuring of the risk management systems within HBOS, which were generally working well.

1431. PwC's Skilled Persons Report contained a large number of specific recommendations for HBOS to take forward to improve its risk management framework and a Group action plan was established to address these recommendations. Overall, however, the report concluded that the structure was working well in practice.

1432. The PwC report, together with the progress made by HBOS on the remediation of control risks, gave the supervision team enough comfort to reduce the ICR back to 9% in December 2004. It was made clear to the firm in the December 2004 ARROW letter that the removal of the capital add-on anticipated that further remediation work would be taken and that supervision was relying on the firm to take this forward: *'Following the skilled person's review of the Group's risk management framework we are content that this is fit for purpose. We will be seeking to place considerable reliance on the Group Internal Audit and Group Risk functions during the regulatory period of this assessment. This reflects our confidence in the calibre and expertise of these functions'*. As noted in the minutes of the FSA's December 2004 ARROW validation panel, which was chaired by the MRGD Director, Mr Page, the basis for the reliance placed on Group Internal Audit and Group Risk to deliver a number of RMPs *'follows close contact with these functions, with us drawing comfort from their effectiveness to mitigate risks'*.

1433. Despite closing the RMP action on Group Risk, the supervision team also communicated to the firm that '*the Group Risk functions still need to enhance their ability to influence the business and we see this as a key challenge for the new Director of Risk* [Ms Dawson]*'*. The supervision team followed this up through the C&C relationship with Group Risk.

1434. In light of the overall conclusion of the PwC report, it was justifiable for the supervision team to place reliance on HBOS's control functions at that point in time. However, it is surprising that the FSA and the firm continued to rely on this assessment given that, as set out in the section below, over the twelve months following publication of this report there were a number of changes to HBOS's risk management personnel and processes.

Assessment of Group oversight of controls during the Review Period

Group Risk

1435. Following PwC's 2004 report, the supervision team did not carry out any in-depth work on the issues relating to HBOS's risk management framework during the Review Period, beyond C&C supervision. However, the supervision team met regularly with Group Risk throughout the Review Period, typically on a monthly basis.

1436. In January 2005, Ms Dawson was appointed to the newly created role of Group Risk Director (GRD). The FSA informed HBOS at that time that her approval to perform control function 10 (CF 10)(261) would be put on hold, pending investigation of the whistleblowing allegations raised by the former Head of Group Regulatory Risk (GRR), Mr Moore. In consultation with the FSA, HBOS's Audit Committee appointed KPMG to conduct a review of the allegations (see Box 4.10 for further details).

1437. On 19 January 2005, the manager of the supervision team called Mr Crosby to raise concerns about Ms Dawson's appointment. The main cause for concern was noted as: *'her behaviour since the decision to appoint her which raised doubts about how open she would be with FSA (particularly … denying that she and Paul Moore had not seen eye to eye in the past); and the potential conflict of interest she had in providing oversight to her previous area of responsibility (Advisory Sales)'.* Mr Crosby said that he thought Ms Dawson had all the right incentives in place to make the

(261) A control function relates to the carrying on of a regulated activity by a firm, as specified under section 59 of the FSMA (Approval for particular arrangements). CF 10 relates to the compliance oversight function.

relationship with the FSA work and a factor in judging her success would be the quality of the relationship. He also asserted that she had to make a success of the role to be able to *'use it as a launch pad for a more senior role'*. This reflects how the GRD was seen within HBOS as a developmental role. This is considered further in Part 3.

1438. The issue of Ms Dawson's suitability and experience for the role was also discussed in a call between the supervision team manager and HBOS's Company Secretary on 8 March 2005. The Company Secretary said that *'James Crosby had made the point that the FSA should not be seeking to second guess his decision on the appointment'*. He also acknowledged that Ms Dawson was not being appointed as a technical risk specialist and that they were *'very comfortable with the Risk team that would support her on the technical subject matter'*. The supervision team manager noted that the issue of support had been discussed previously with Ms Dawson and *'it had been apparent then that there were a number of avenues of support available'*.

1439. There is also evidence that HBOS senior management decided to pursue an internal appointment for the GRD role, having previously engaged a head-hunter to review the market for external candidates, *'once it was clear that the FSA had accepted the findings of the PWC s166 review of HBOS risk management report… due to the significant difference in cost'*.

1440. Despite the supervision team's initial concerns about Ms Dawson's suitability for the role, the FSA approved her appointment following a presentation by KPMG of its preliminary findings to HBOS's Audit Committee in March 2005. The minutes of this meeting recorded: *'Overall KPMG concluded that they had seen nothing to say that Jo Dawson was not a fit and proper person to fulfil the job. A tough and rigorous process had been used in connection with this appointment, using external advisers appropriately. Management were convinced that she had the skills to enable her, with technical support from her team, to be very effective in this role'*. The final KPMG report also set out that it *'does not believe that the GRD necessarily needs to have strong technical competencies in the wide range of HBOS generic risk categories… especially if they are supported by individuals with the appropriate technical skills. This is consistent with Chapter 10 of the FSA's Supervision Manual concerning Approved Persons which does not prescribe the particular skills an individual undertaking a CF10 role is required to possess'*.

1441. The approval of a GRD who did not have technical risk expertise was justifiable at the time given the external endorsement from KPMG, the findings of the earlier PwC report, the technical support available to Ms Dawson at that point and the reassurance from Mr Crosby that a key area of focus for her would be the relationship with the FSA.

1442. Following this appointment, the supervision team sought to increase its oversight of HBOS's Group Risk function by changing the frequency of C&C meetings with the firm's GRD from quarterly to monthly.

Box 4.10: Mr Moore's whistleblowing allegations

Background

Mr Moore was Head of GRR at HBOS from 1 January 2004 to 31 December 2004, reporting to Mr Ellis. Following a restructuring of Group Risk in 2004, HBOS decided to upgrade the function by appointing a new GRD. The FSA was briefed in confidence by Mr Ellis on 25 October 2004 that HBOS was planning to appoint Ms Dawson as GRD and the intention was that Mr Moore and Dr Angela Smith, Chief Financial and Operational Risk Officer, would be her two direct reports.

However, Mr Crosby informed the supervision team on 10 November 2004 that it had been agreed with Mr Moore that he would be leaving HBOS and that this intention would be made clear immediately. According to FSA records, Mr Moore told the FSA that he was informed of his redundancy on 8 November 2004 and it was announced within HBOS on 12 November 2004.

Mr Moore's allegations

Mr Ellis called the supervision team on 14 December 2004 and said that it *'looked like there were going to be difficulties'* over Mr Moore's departure. The FSA record of this call noted that the firm's *'approach was going to be to have a thorough whistleblowing investigation'* and that Mr Ellis' initial thoughts were that someone from PwC, that had worked on the 2004 Skilled Persons Report, would be asked to do the investigation on the grounds of independence, as Mr Moore had formerly worked for KPMG.

Mr Moore subsequently met with the supervision team, together with his solicitor, on 20 December 2004 to discuss his departure from HBOS. The FSA's internal record of this meeting and Mr Moore's *'Outline of Case'*, which was shared with the FSA, summarised Mr Moore's allegations:

- he had been dismissed from his job because he had done it well and had made whistleblowing disclosures while in the role;
- Mr Crosby had failed to comply with HBOS's HR policies in dismissing him;
- Ms Dawson was not 'fit and proper' to be approved by the FSA; and
- there was a cultural indisposition to challenge by Regulatory Risk within Retail (although Mr Moore indicated to the FSA at the time that he had experienced good and constructive relations with all other Divisions in the Group).

The supervision team informed Mr Moore at the end of the meeting that it would consider the information that he had provided but, due to *'confidentiality'* reasons, it was *'unable to say how we would follow up matters with the firm'.*

Actions taken by the FSA in response to the allegations

The supervision team took the following actions in response to the allegations:

- reported the allegations and proposed handling to FSA senior management via the FMC;
- consulted with HBOS on commissioning an external review of the allegations; and
- postponed the approval of Ms Dawson.

Choice of reviewer

The supervision team considered the issue of which external firm should be appointed by HBOS to carry out the investigation in an exchange of emails with the FSA's Markets Division (Markets). The supervision team considered PwC, which had been suggested by Mr Ellis, to be '*potentially conflicted because they carried out the s166 on HBOS' Risk Function*'. The supervision team recognised that KPMG was also '*potentially conflicted*' as HBOS's external auditors but noted that: '*i) we have tended to be more satisfied with the depth and quality of KPMG's work in the past; and ii) potentially another part of KPMG, i.e. not Audit, could undertake the investigation and therefore minimise any conflict*'. Markets advised the supervision team that the risk could be further addressed if Mr Moore consented to KPMG conducting the inquiry given that he was previously a KPMG partner. Although the supervision team sought Markets' suggestions as to who else could carry out the review, the Review found no record of the supervision team giving further consideration to other firms beyond KPMG and PwC.

The supervision team sent an email to the HBOS Company Secretary on 23 December 2004 setting out the FSA's position and proposed steps to mitigate KPMG's potential conflict of interest: *'The risk would be reduced substantially by asking the non-audit arm of KPMG to do the work and if Paul Moore gave his formal consent to the choice of investigator. If this could be achieved and HBOS was content with the residual risk associated with appointing KPMG I expect FSA would not object to their appointment'*.

The supervision team called the Company Secretary on 6 January 2005 to ask for an update on progress in commissioning the investigation and was advised that HBOS was in discussions with KPMG. The Company Secretary said he *'had not broached the issue of KPMG doing the investigation with PM* [Mr Moore]. *However, PM had not indicated he had any objections to any particular firm being appointed*.' The FSA was also advised that KPMG was considering two partners at KPMG as '*…it appeared that they had not dealt with PM in his time at KPMG and had neutral views in relation to him'*.(262)

The review was undertaken by KPMG's forensic practice, which was separate from the financial services audit team. KPMG's lead investigator said in interview for this Review that he did not know Mr Moore at the time. However, the other KPMG Partner involved in the review had previously worked in the same team and on similar projects as Mr Moore during his time at KPMG. Although the FSA was given copies of both partners' CVs, it is not clear that the connection between Mr Moore and the KPMG Partner was brought to the FSA's attention.

KPMG's lead investigator told the supervision team on 21 January 2005 that he had spoken to both Mr Moore and Mr Ellis to clarify the issues that needed to be covered. KPMG subsequently met the supervision team to discuss the scope of the review. The FSA did not, however, have a formal role in signing off the terms of reference as the review was commissioned directly by HBOS rather than as a s166 Skilled Persons report.

Outcome of KPMG's Review

KPMG undertook around 80 hours of interviews and met with 28 individuals, including the NEDs, Mr Crosby, Mr Ellis, Mr Hornby (then Head of Retail), Mr Moore, Dr Smith and the supervision team at the FSA. Its final report to the HBOS Board was dated 28 April 2005 and concluded that:

- *'During 2004 Mr Moore strengthened the GRR function through the recruitment of strong individuals and by developing more of a team spirit with the GRR function. The 2005/06 Business Plan … indicates that the GRR function was refining the role of oversight. However, the confusion surrounding GRR's remit and the interaction between GRR, RRR* [Retail Regulatory Risk] *and the Retail Business during 2004 were not dealt with';*

(262) KPMG advised the Review that they were not aware that the FSA had asked HBOS to obtain Mr Moore's consent to their appointment.

- *'With strong communication and relationships between GRR, RRR and the Retail business the lack of clarity as to GRR's remit could have been overcome. As neither of these was present these difficulties were not addressed and were a recurring issue throughout 2004… we believe that the opportunity to deal with these issues would naturally fall to the Head of GRR who could have taken steps to improve the clarity of GRR's remit and its interaction with other teams. It is apparent that relationships between GRR and its stakeholders… deteriorated during 2004. It is clear that the relationship between Mr Moore and Ms Dawson was difficult for some time'*;

- *'We consider that the structure and reporting lines of GRR are appropriate'*;

- *'We consider that the process adopted for the identification and assessment of candidates for the GRD position and appointment of Ms Dawson to be appropriate … The quality of her relationships will be a critical success factor in her new role. However, we do not believe that the evidence reviewed suggests that Ms Dawson is not fit and proper to undertake the GRD role'; and*

- *'There are no defined processes relating to the redundancy of positions above level 5 i.e. the Head of GRR role at Level 8'.*

In addition, KPMG concluded that *'the quality of Mr Moore's relationships with the key stakeholders … was a key factor in him being asked to leave the Group. We have seen no evidence to suggest that Mr Moore's redundancy was in response to him performing his job too well'.*

A review into such allegations, by its very nature, requires judgements to be taken and an important factor for KPMG in reaching its conclusions was the consistent feedback received from the NEDs and senior executives. During a meeting with the supervision team following the completion of the review, KPMG said that *'the fact that the NEDs were so outspoken in their criticism of PM meant that the case against him was so largely incontestable'.* After reviewing KPMG's report, the FSA met the KPMG team with HBOS also in attendance in May 2005. The supervision team questioned KPMG about the report and was satisfied with their conclusions. Following this meeting, the supervision team considered the case to be closed.

Appropriateness of the FSA's actions

The FSA responded appropriately to Mr Moore's whistleblowing allegations by delaying the approval of Ms Dawson and ensuring that an external third party was commissioned by HBOS to investigate the allegations. However, the appointment of HBOS's external auditor, KPMG, to undertake the review was inappropriate even by the standards of the time, particularly given Mr Moore was a former KPMG partner. Moreover, given the intention was that Mr Moore should agree to the choice of investigator, the supervision team failed to press HBOS to gain his formal consent to appoint KPMG. Nonetheless, Mr Moore said in interview for this Review that he did not object at the outset of the investigation to either the appointment of KPMG or the individual partners involved.

The review carried out by KPMG appears to have been comprehensive. Indeed, following the completion of the report, Mr Crosby wrote to KPMG to formally complain that they '*interviewed far too many people for far too long*' and that their '*interviewing style was unnecessarily hostile*'.

The report concluded that the allegations could not be substantiated, partly on the basis of the views of the NEDs. The supervision team did not have any concerns about the NEDs at that time so it was reasonable for the team to rely on the outcome of this report.

KPMG did make some recommendations as to how GRR could be made more effective, for instance, through clearer divisions of responsibility with divisional risk functions. The supervision team reported to the FMC that it would *'follow up with HBOS how these are taken forward.'* There is evidence that the FSA followed up on the issue of the effectiveness and influence of Group Risk over the divisions during monthly C&C meetings with Ms Dawson.

1443. The supervision team expressed concern on a number of occasions during monthly C&C meetings with Ms Dawson that the business was racing ahead of the capability of its systems and controls. The rapid expansion of International was of particular concern. As set out in Section 4.4.4, *Supervision of asset quality in International*, this prompted the FSA to visit both Australia and Ireland but the supervision team emphasised that it would rely on a review by Group Risk. HBOS's commercial property book and *'Retail pushing sales at the expense of quality'* were also seen as examples of where the FSA saw growth moving faster than controls. The FSA told Ms Dawson in May 2005 that it was *'not comfortable that the level of control matched the scale of the group's growth ambitions'*. Ms Dawson acknowledged that she had concerns about the quality of divisional risk functions. The need for more proactive risk management was also discussed at this meeting, particularly the need for divisional risk functions to be more proactive in looking for possible risks so there was less reliance on Group Risk to do this.

1444. Throughout 2005 and in early 2006, the supervision team raised a number of concerns about the effectiveness of Group Risk, particularly in relation to its influence, or lack thereof, over the divisions. For example, during a monthly C&C meeting with Ms Dawson in March 2005, the supervision team said that there *'seemed to be some tension between the GR* [Group Risk] *functions and the divisional functions in terms of how clearly the messages are communicated and whether the balance of the messages are too positive and therefore the point is missed or whether the messages are too negative and therefore this causes friction'*. The influence of Group Risk was discussed again with Ms Dawson in September 2005 when the supervision team noted that the FSA saw *'a key test as being GR's ability to get the divisions to stop doing things'*. An FSA internal briefing indicates that this was still a concern in January 2006: *'We generally consider the quality of work done by Group Risk to be good. However, we continue to challenge the function's ability to influence the business divisions and to ensure risk management is effectively embedded across the Group'*.

1445. Following the departure of Mr Moore in 2004, the supervision team was informed in mid-2005 that another key risk expert, Dr Smith, would be leaving HBOS, *'having failed to settle under Jo Dawson's leadership'*. Ms Dawson planned to take on Dr Smith's four direct reports. The supervision team saw the departure of Dr Smith as a loss, as her *'knowledge and expertise of the risk spectrum provided a good oversight and helped to bring things together'*. The supervision team told Ms Dawson that a challenge for her would be to see if she could continue to do this after Dr Smith's departure. Concerns were also raised with Mr Crosby in June 2005 that Dr Smith's departure *'could significantly weaken the group's second line of defence and its ability to effectively provide leadership and challenge'*.

1446. Prior to the FSA being informed that Dr Smith would be leaving the firm, she met with the supervision team in March 2005. During this C&C meeting Dr Smith raised some serious concerns about HBOS's risk management. While she referred to being '*satisfied that the systems and controls throughout HBOS (bar the international businesses) was commensurate with the risks being run by the business'*(263), Dr Smith expressed a concern that HBOS senior management *'placed little weight on enhancing the quality of risk management within business lines'*. The supervision team's record of this meeting noted that Dr Smith felt this was illustrated in a number of ways:

- Group Financial and Operational Risk's (GFOR) remit and resources were *'being largely limited to that of oversight and functional leadership of HBOS business as usual as opposed to pushing the Group towards leading edge risk management. "Proactive risk management was not an HBOS thing"'*;

(263) See Section 4.4.4 for further details on the supervision of asset quality in International – The December 2004 ARROW letter had previously identified that the planned growth in International was an area of potential risk and an RMP action was set to improve the controls in both Australia and Ireland.

- *'the need to embed new risk management practises* [sic] *into the business – the Use test in Basel II terminology – was not being driven sufficiently hard by senior management. Given this, and with GFOR not in a position to drive the project, he does not believe the Group has a credible chance of attaining the required standards for AIRB status'*; and

- *'the appointment of the non-technical Jo Dawson as Group Director of Risk and Basel project sponsor* [was seen] *as a further barrier to the Group achieving success in this area'.*

1447. Dr Smith also said that the *'lack of appropriate resources was a conscious decision by the Group Board and reflected the risk culture among the HBOS senior management'.*

1448. Dr Smith had previously been a candidate for the role of GRD, to which Ms Dawson was appointed, and the supervision team noted that: *'this background might provide some colour as to why* [Dr Smith] *came across so negatively'.*

1449. An internal FSA briefing for a meeting with Mr Hornby and Ms Dawson, which noted that *'there is an issue over whether the HBOS senior management buy into enhancing risk management on a business level as opposed to a strategic level'*, suggested that the supervision team took the concerns raised by Dr Smith seriously. The supervision team also continued to question the effectiveness of Group Risk after Dr Smith's departure. However, her concerns do not appear to have prompted the team to undertake significant follow-up action or investigation.

1450. The issues raised by Dr Smith, together with the FSA's wider concerns about the experience and effectiveness of Group Risk, in retrospect should have prompted the supervision team to question the amount of reliance that could be placed on HBOS's control functions. In turn, this might have prompted a follow-up review on the effectiveness of risk management at HBOS.

From early 2006, there is evidence that the supervision team's views of the effectiveness of Group Risk started to improve. An internal FSA briefing in May 2006 noted that: *'Group Risk provides challenge and oversight as well as setting group policies for risk management and providing "functional leadership"… The quality of work done by Group Risk has generally been good'.* It is possible that this, in part, follows Mr Dan Watkins' appointment as GRD in March 2006. An internal FSA briefing noted that his appointment did not raise any particular concerns and he was described as being *'very sound and easy to deal with'.* This view was shared by Mr Tony Hobson, Chair of the Audit Committee: *'Dan Watkins (DW) is the best Head of Risk that he has seen at HBOS… Group Risk as a whole is now very much improved in terms of its influence'.* A presentation to the FSA by Mr Hornby and Mr Watkins in May 2006 also stressed the progress made by HBOS in developing the overall control environment since the merger including investing in Divisional and Group risk management teams, invested in risk tools and technologies and strengthened governance through key appointments and restructuring Risk Committees.

1451. The June 2006 interim ARROW letter recognised that *'the Group's systems and controls are improving'* but considered that there was still more to be done. Accordingly, the supervision team placed reliance on Group senior management to deliver a number of RMP actions. The ARROW letter made it clear that, as part of the on-going C&C dialogue, the supervision team would *'continue to seek assurance that the Group's systems and controls are sufficiently robust for us to place reliance on them'*.

1452. As noted previously, there was a decline in the quality of FSA minutes of C&C meetings from mid-2006 until early-2007, making it difficult to track the degree of challenge provided by the supervision team during this period. Agendas for meetings with Group Risk during this period indicated that there was an increased focus on Basel II implementation and TCF, as well as continuing discussion about conduct issues, such as mortgage endowment complaints and PPI. There was evidence, however, that the supervision team discussed *'Divisional Risk Management effectiveness'* at a meeting with Mr Watkins in November 2006.

1453. In February 2007, Mr Watkins informed HBOS's ExCo that he had recently met the manager of the supervision team, who had stressed the FSA's concerns at the number of control failure issues that had arisen. The minutes of this ExCo meeting recorded that: *'individually these* [issues] *were small scale, but cumulatively they were regarded by the FSA as worrying… these issues were leading to a heightened sense of concern within the FSA about the quality of the HBOS overall control environment'*. The supervision team subsequently informed Mr Watkins in April 2007 that HBOS was *'in the middle towards the lower end for controls'* compared to its peers and it was noted that the scores were skewed by areas with control weaknesses, such as HBOS Financial Services, where there was crystallised risk. Mr Watkins advised the supervision team that Group Risk would coordinate control reviews across the divisions. The reviews would cover the root causes and controls in Retail operational risk, Corporate credit control, financial risk in Financial Services and International expansion.

1454. Although steps were taken by HBOS to try and address the supervision team's concerns, the significant number of control issues prompted a wider focus on HBOS's management, governance and culture in the 2007-08 ARROW discovery meetings. As recorded in the November 2007 ARROW planning pack: *'the increasing number of control failures lead us to believe that the management and systems to support this* [governance] *framework may be weak relative to the size of their business and growth strategy… Our prime objective is to evidence whether the control failures we have seen this year are a symptom of underlying weaknesses'*. Mr Hornby challenged the FSA's assessment of the control framework in a November 2007 ARROW meeting, suggesting that there was *'a perception gap with the FSA'* around controls and that the Medium High score was *'not backed up by the numbers'*.

The supervision team appears to have concluded in February 2008 that the control failings suggested that HBOS was *'accident prone'* (this view of the firm as being *'accident prone'* had also been held by the manager of the supervision team in the middle of the Review Period). The internal FSA briefing which recorded this view also noted that this was '*an accusation that management strongly refute*. *Several major projects are underway to address system and process weaknesses – giving rise to delivery and change risk'*. The April 2008 ARROW letter prompted further challenge from HBOS that the FSA's analysis of its control framework was incorrect. The FSA's record of a meeting in April 2008 with Mr Peter Hickman (Mr Watkins' successor and the firm's third GRD during the Review Period) to discuss HBOS's feedback on the draft ARROW letter noted that the supervision team *'will not be changing the letter unless for factual accuracies – we believe a lot of the comments are overly defensive and reflect views rather than factual accuracies'*. The supervision team also noted that the remedial programmes instigated by HBOS *'were largely backward looking programmes which dealt with historic issues and demonstrate HBOS's flat-footed approach… We expect the firm to demonstrate robust controls as they should be doing to the audit committee and board.'*

1455. At the time of this meeting with Mr Hickman, HBOS was reviewing its risk resources across the Group. A further objective of this meeting was therefore to understand the changes to HBOS's Group Risk function. The supervision team's briefing for this meeting recorded that *'we may need to challenge if they are reducing staff and the implication this could have on controls'*. An internal FSA briefing for a subsequent meeting with Mr Hickman on 29 July 2008 indicated that the supervision team again had concerns about the effectiveness of Group Risk, specifically in relation to its interaction with Corporate. The briefing note set out the team's intentions to seek clarification over Group Risk's role and oversight of Corporate's governance arrangements and assets, and how the '3 lines of defence' worked in practice. The supervision team concluded after the meeting that: *'hitherto Group Risk has been weak; not pressing for a portfolio approach in Corporate'*. There is no evidence that the FSA instigated any remedial steps to address the weaknesses identified in Group Risk in summer 2008.

Group Internal Audit

1456. Throughout the Review Period, the supervision team placed reliance and trust on Group Internal Audit, HBOS's third line of defence, to deliver a number of RMP actions. In the early part of the Review Period, this broadly reflected the supervision team's '*confidence in the calibre and expertise'* of this function following the December 2004 ARROW assessment. The manager of the supervision team at the time of the 2004 ARROW recalled in interview that the team was *'happy with the quality of reports that they* [Group Internal Audit] *produced so … was prepared to have them do follow-up work to confirm that things had been addressed to our satisfaction'*. This view may have, in part, been informed by an ARROW meeting in October 2004 with the Chair of the Audit Committee who said that he was very happy with the function and that the Head of Group Internal Audit was *'doing a great job'*. The reliance placed on Group Internal Audit at this time was supported by the December 2004 ARROW validation panel. However, the panel did *'suggest that the FSA should ask the Audit Committee for an independent assessment of the effectiveness of the GIA in due course'*.

1457. By May 2006, the supervision team still viewed the quality of HBOS's Internal Audit work favourably and continued to place reliance on this function. An internal FSA briefing noted that Internal Audit's work plan covered the key risks and that it interacted well with Group Risk: *'co-ordinating their plans so that they do not duplicate and also where appropriate working jointly on reviews so that a sounded* [sic] *assessment of the control environment in an area can be delivered. As a result we have been content to place reliance on IA* [Internal Audit] *in the RMP'.*

1458. The supervision team typically met with Mr Hobson, Chair of the Audit Committee, twice a year and these meetings were viewed by the supervision team to be *'frank and open discussions about the risks in the business and the strengths of the senior management team'.* The supervision team also noted in an internal briefing that Mr Hobson *'in our view is excellent. He is always very well informed about the business and astute to the risks within it'.* Reassurances from Mr Hobson at a meeting on 8 November 2006, for example, that the *'AC* [Audit Committee] *is keeping a strong eye on developments in Ireland and Australia'* and that *'Group Risk as a whole is now very much improved in terms of its influence'* would have given some comfort to the team about areas of concern.

1459. Group Internal Audit was subject to an external third party review in July 2007 by PwC. As set out in Part 3, the report, which was shared with the FSA, concluded that Group Internal Audit was discharging many of its responsibilities in line with its remit and noted a number of strengths. The report did, however, also highlight a number of key areas for development, including reporting lines, skills and talent development, resource and audit planning, and working practices (see Part 3, Section 3.4.4, *'Third line of defence'* for further details). Similar concerns that Internal Audit was *'under-resourced'* had *'poor quality of staff'* and *'problems recruiting'* were raised with the supervision team by a member of HBOS's Group Credit Risk function in October 2007.

1460. Both the PwC report and comments by Group Risk prompted *'concerns around the effectiveness of the Group Internal Audit'* function by the supervision team. This was subsequently an area of focus in the 2007-08 ARROW discovery meetings with HBOS senior management and members of the Board, as well as with both PwC and KPMG. An internal FSA briefing for the ARROW meeting with Group Internal Audit set out that the desired outcome of the meeting was to ensure that the supervision team had *'sufficient information to assess whether the Group Internal Audit function is effective'.*

1461. The April 2008 ARROW letter set out the FSA's assessment of this function: *'We looked carefully at Group Internal Audit and we heard the consistent message that the function provides core assurance across the Group. Outside of the core audit activities we consider that there is more scope for improvements to be made – for example in providing more co-ordinated assurance in association* *with Group risk, and aiming to be more demand-led. The Group should also be mindful of the potential impact of staff rotation and business skills'.*

1462. RMP actions were set by the FSA in April 2008 to ensure that the *'HBOS Group Internal Audit function provides core assurance to management and effective assurance work across the business'.*

4.7.5 Assessment of the degree of reliance that could be placed on HBOS senior management

1463. As noted earlier in this Report, the supervision team's assessment of the firm's relationship with the regulator was a factor in determining the degree of reliance that could be placed on the firm's senior management. The relationship with the firm was also a key part of the risk scoring for management, governance and culture and it was one of the dimensions of the 'fit and proper' standard set for firms, as expressed in the FSA's Principles for Businesses.

1464. The FSA Principles were a general statement of the fundamental obligations of firms under the regulatory system. FSA Principle 11 required that *'a firm must deal with its regulators in an open and co-operative way and must disclose to the FSA appropriately anything relating to the firm of which the FSA would reasonably expect notice'.*(264) As such, the FSA placed importance on achieving an open and co-operative relationship with firms.(265) Where this was judged to be the case, firms could benefit from a 'regulatory dividend' (as described in Section 4.2.3, *'The FSA's approach to supervision in the pre-crisis period'*).

1465. The danger in this approach was that it could result in too much reliance being placed on senior management to identify any deficiencies in systems and controls and then to correct them. In turn, this created the danger that supervision teams might not only fail to address substantive risks and issues, but also fail to identify and ensure the mitigation of important control issues.

1466. As set out in Section 4.3.8, the supervisory relationship with HBOS was held up as a positive example compared to most of its peers. The supervision team's view of the relationship was summarised in an internal briefing dated 19 June 2007: *'There is a high degree of openness with HBOS; the* [supervision] *team receive regular management information, have access to all levels of senior management and HBOS are proactive in engaging the FSA early with any issues'.* This contributed to the relatively neutral management, governance and culture probability scores for HBOS. Together with the apparently benign economic outlook and resource constraints, these factors drove the insufficient pace and intensity with which the supervision team progressed identified risks.

1467. Both the supervision team and the firm certainly appear to have believed that the regulatory dividend applied to HBOS. For example, the minutes of an HBOS ExCo away-day meeting on the 19 June 2007 recorded that: *'The Group's good relationship with the FSA and the 'regulatory dividend' was starting to be eroded'.* In addition, an early draft of the 2008 ARROW letter expressed a desire to *'continue the open and co-operative relationship and maintain the regulatory dividend'.* However, beyond the C&C challenge initiative), the Review found little evidence of what this entailed for HBOS.

1468. The supervision team's views of individuals were based on routine C&C supervision and ARROW meetings. The Review did not find any evidence of changes to the firm's senior management team during the Review Period prompting the supervision team to reassess its high level view of the relationship with HBOS.

(264) FSA Handbook: Principles for Business (PRIN) section 2.1 – http://fsahandbook.info/FSA/html/handbookl/PRIN/2/1.
(265) See *Principles-based regulation: Focusing on the outcomes that matter*, April 2007, section 3.2, www.fsa.gov.uk/pubs/other/principles.pdf.

1469. The fact that HBOS senior management often appeared to have empathy with or share the supervision team's concerns, together with the confidence with which HBOS senior management presented itself as being on top of issues, was a factor in the continued reliance placed on the firm. This confidence, for example, was demonstrated in a January 2008 email from Lord Stevenson to Mr Hornby, summarising the post-ARROW feedback session with the FSA, and subsequently forwarded to the supervision team: *'We hope that they* [the FSA] *see a major part of their job as making a judgement as to the extent to which they have confidence in the Board and senior management – and that after the credit crunch I think any right minded regulator looking at our performance on the big credit issues and the big liquidity issues should give us a very large tick'.*

1470. However, the supervision team might have been more sceptical about the effectiveness of the relationship especially in light of key outcomes not being delivered at a reasonable pace within the Review Period, despite assurances from the firm that issues would be addressed. For example:

- the continuing and increasing reliance on the wholesale funding market year on year, despite HBOS senior management assurances that it was taking action to reduce this dependency and contradictory statements in regard to the level of reliance on wholesale funds in the future (see Section 4.5.4, '*Supervision of HBOS's liquidity and Treasury assets in the pre-crisis period*');

- continuing growth in Corporate despite assurances that it would not be *'chasing deals'* (see Section 4.4.3, '*Supervision of asset quality in Corporate*'); and

- the difficulties experienced by Corporate in implementing Basel II due to data issues and available MI (see Section 4.6.3, *'Basel II implementation'*).

1471. When the supervision team did encounter strong challenge from certain individuals, it did appear to take appropriate action. For example, the supervision team followed up its concerns about the CEO of International during a meeting with Mr Crosby (see Section 4.4.4, '*Supervision of asset quality in International*'). The supervision team also continued to push HBOS to apply more stringent stress tests to its commercial real estate portfolio in 2005, despite the view from HBOS senior management that this exercise was '*over the top*' (see Section 4.4.3, '*Supervision of asset quality in Corporate*'). It is not unusual to receive some degree of challenge from a regulated firm. However, the relationship with HBOS contrasted greatly to that with RBS, with the latter standing out in terms of the greater regularity and vigour of RBS's pushback to the FSA.

1472. As noted in Section 4.8, *'Contingency planning'*, the FSA started to become more intrusive following the failure of Northern Rock. However, this attention was not always welcome. For example, following an FSA request for information, which was also sent to other major firms, about the qualifications of the CEO and Chairman, Mr Hickman responded robustly: *'It is fair to say that we are concerned by this request and the implication that the FSA may be pandering to such lines of questioning'.*

1473. While HBOS did not always welcome the increased intensity of FSA supervision of key issues as the financial crisis deepened, incidents of discord were infrequent and were not seen to be indicative of a breakdown in the open and co-operative relationship. By the end of the Review Period, the management, governance and culture probability score had been raised to medium high, which was still a relatively neutral score. In the April 2008 ARROW letter the supervision team wrote: '*We recognise and welcome the open dialogue that exists within the Group and with the FSA and aim to continue the open and constructive relationship we have with you. We also aim to rely on your senior management to achieve RMP outcomes, with the FSA carrying out focussed reviews where appropriate'.*

4.7.6 Assessment of board effectiveness

1474. During the Review Period, analysis of corporate governance was less structured and rigorous than is now the case. Board effectiveness reviews were increasingly encouraged as part of wider corporate governance good practice but board composition and testing its overall effectiveness were not generally subject to regular FSA analysis unless a specific cause for concern existed.

1475. The supervision team did not undertake a formal assessment of the effectiveness of the HBOS Board during the Review Period. However, they formed informal views through meetings with the Chairman and other members of the Board. Key pieces of management information were also routinely shared with the supervision team, such as the Board MI packs and Audit Committee papers.(266)

1476. An internal FSA document, written in May 2006, described the HBOS Board as having '*an appropriate and diverse range of skills'*. The supervision team noted that the Board appears to be *'collegiate and challenging'* and that the Chairman does not seek to *'dominate the Board discussions and actively draws in contributions from others'*. In the absence of evidence in the document, it is difficult to know whether these comments were evidence-based judgements or merely impressions.

1477. Board effectiveness issues were also covered during a meeting in January 2008 between the supervision Head of Department and the HBOS Chairman to discuss the ARROW findings. The FSA record of this meeting noted that Lord Stevenson *'is in seamless touch with the NEDs and is sensitive to their concerns … there is continuous discussion with the board members between official meetings. He encourages debate. He doesn't expect massive differences and arguments at the official board meetings but to be dealt with offline. He wants independent directors to stay for a while to fully understand and add value to the business'*. The supervision team also viewed positively the presence of NEDs on the Risk Control Committees as it helped them to '*gain greater exposure to and knowledge of the business of a given division'* and, in turn, *'provide more effective challenge at the Board'*.

1478. While the composition of the HBOS Board was broadly typical for a large UK bank at the time, in retrospect it was not appropriate for a bank with significant exposure to corporate and international business with a risky funding strategy and profile. Over the Review Period, the supervision team did not recognise the importance of having a board constitution that more strongly reflected the evolving business risk profile.

1479. The supervision team generally did not identify some of the main failings by the HBOS Board, such as its failure to instil an appropriate focus on risk. The FSA's informal approach to assessing HBOS's corporate governance was insufficient to identify the failings. Furthermore, judgements on the adequacy of the governance framework, the effectiveness of the Board and the degree of reliance that could be placed on HBOS senior management and controls, were largely taken at the supervision team level, with input from the team's Head of Department depending on the level of experience of the Manager in charge at the time. The wider FSA senior management team were generally not involved in such judgements, outside of the ARROW panel process. See Section 4.3.7 for further details regarding the involvement of FSA senior management in the supervision of HBOS in the pre-crisis period.

(266) FSA records indicate that management information regularly shared with the HBOS supervision team included: Group Audit Committee agendas, papers and minutes; Divisional Risk Control Committees (RCCs) agendas, papers and minutes; Monthly Board Management Information Pack (Blue Book); Monthly Credit Portfolio Report (GCRC); Quarterly Credit Portfolio Report (GCRC); Quarterly Credit Trends Report (Board); Monthly GALCO Reporting Pack.

4.8 Contingency planning

4.8.1 Introduction

1480. This section examines the contingency planning work undertaken by the FSA from September 2007 until 1 October 2008 (defined for the purposes of this chapter as the contingency planning period).

1481. The objective of the FSA's contingency planning work evolved over time. In the context of the failure of Northern Rock in September 2007, planning was initially intended to address the impact of the ongoing disruption of the wholesale funding markets. However, from early on, a small number of financial institutions, including HBOS, were identified as relatively vulnerable and the focus of planning explicitly addressed the prospect of failure, initially as a downside scenario and eventually as a central scenario.

1482. This section considers how the FSA stepped up the intensity and depth of its supervision of HBOS over the contingency planning period. It also considers whether there was more that the FSA could have done during HBOS's last year to influence the final outcome of failure, both in the context of the time and with the benefit of hindsight.

1483. The FSA clearly did not operate in isolation during this period. However, consistent with *The RBS Report*, this Report does not consider the actions taken by the other Tripartite authorities (i.e. the Bank of England and HM Treasury) in response to the crisis of the financial system beyond noting the relevant dealings with the FSA and their impact on HBOS.

1484. The contingency planning period is of interest for a number of reasons. It was rich in judgements, some of which were without precedent at that time and taken within the context of an extremely challenging and fast-moving environment of serious financial dislocation. This period also illustrates the challenge of taking mitigating actions once risk has crystallised and/or a firm has become relatively vulnerable in the market.

1485. It is evident through the contingency planning period that there was an unprecedented level of FSA senior management involvement in the supervision of HBOS, including by the FSA Chairman, Sir Callum, and Chief Executive, Sir Hector, in particular from March 2008. FSA senior management were consistently involved in decision-making on contingency planning issues for HBOS through discussions at ExCo and in Tripartite fora, as well as through the escalation of issues requiring senior management intervention. In addition, FSA senior management, including the Chairman and Chief Executive, had many discussions directly with the firm through this period.

1486. While the FSA Board was kept abreast of key developments and had sight of the most significant sector-wide and firm-specific issues, the Board, as a whole, was not involved in active decision-making on contingency planning issues.

4.8.2 September 2007 – February 2008

1487. Previous sections of this Report provide an understanding of the context in which HBOS operated leading up to and for most of the Review Period, as well as the regulatory environment and framework in which the FSA operated.

1488. In response to the tightening of wholesale funding markets and the failure of Northern Rock, the FSA took action quickly to review the liquidity and funding position of firms deemed to have business models similar to Northern Rock. HBOS was one such firm. This review instigated a number of contingency planning work streams which developed the Tripartite authorities' understanding of a range of issues and proved useful as the financial crisis intensified. The wholesale funding dislocation was at this point in time seen as temporary, and the crisis was one of the financial system rather than also of the real economy as it eventually became. Even as late as May 2008, the Bank of England commented, in its Financial Stability Report, that: *'Looking ahead, the most likely outcome for the financial system is that conditions improve gradually as measures … are taken to restore market functioning and to bolster confidence in the resilience of financial institutions. Low prices should induce investors to return to markets, leading to a recovery in asset values and a strengthening of balance sheets.'*

1489. As noted previously, HBOS was added to the FSA Watchlist in October 2007. This reflected the increased focus on HBOS's liquidity and funding from August 2007 and led to the introduction of weekly (which later became daily) funding calls and analysis of data that had previously not been gathered. While there have been many further developments since, both domestically and globally, this work was advanced for its time. However, given that liquidity had not been a key area of focus for the FSA prior to this period, the ability to undertake this work most effectively was hampered by the shortage of staff with the right skills as well as the inadequate quality of data received from firms.

1490. At the same time, HBOS began to look at its ability to respond to a liquidity crisis and established its own contingency planning work stream in September 2007. This sought to identify possible scenarios and key triggers for escalating plans. Key actions were identified, such as increasing liquidity monitoring, taking steps to reduce lending growth and increase customer deposits, and addressing the risk of a loss of confidence in HBOS and/or continued deterioration of liquidity conditions.

1491. Key decisions taken by the firm were shared openly with the supervision team. This included the decisions initially to focus reductions in asset growth on Retail, rather than Corporate and International, and to phase its actions to slow growth over time. Some of the thinking behind these decisions was also shared with the FSA as set out below, and appears to have gone unchallenged:

- '*actions to slow down growth will be phased, in part not to give any adverse signals to the market but also to avoid overshooting should the liquidity conditions start to improve*';
- '*retail assets are seen as the quickest and least franchise damaging to slow. Key to the proposed slowdown is removing their net lending target (share of new mortgage market) that has already been agreed with key shareholders*'; and
- *'they based their stress test around August-December 2008 timeframe, where funding pressures really kick in'*.

1492. Despite the fact that HBOS was a peer outlier in terms of its reliance on wholesale funding, the evidence does not indicate a sense of urgency by the FSA in the early part of the contingency planning period, beyond the step up in liquidity monitoring. HBOS appeared to be weathering the early storm reasonably well following steps taken in August 2007 to renew its wholesale funding. At that time, the possibility that HBOS would fail still appeared extremely remote. As such, business as usual work by the FSA continued, such as the ARROW review.

1493. It is clear from working papers that other smaller institutions, such as B&B and A&L, were initially of greater immediate concern to the FSA. As such, they were accorded more FSA senior management time. For example, a briefing to Sir Callum in October 2007 noted that HBOS's *'fundings are far more diversified than the likes of Northern Rock, Bradford & Bingley and Alliance & Leicester. HBOS has a much more controlled growth rate than Northern Rock and therefore does not have to support rapid growth with wholesale funding'*. The minutes of the September 2007 FSA Board captured a discussion on firms affected by market conditions in which only Northern Rock, A&L and B&B were referenced in the minutes.

1494. Indeed, for most of the contingency planning period, HBOS was considered a potential 'saviour' for other more vulnerable institutions, as it was considered by FSA senior management that this would not only save the smaller banks but also help to address HBOS's retail deposit shortfall (see Box 4.13).

1495. Through the latter part of 2007 and into 2008, with firms' 'survival days'(267) shortening rapidly, the authorities realised that the financial dislocation was not a short-term scenario, as previously thought. Reflecting this, contingency planning increased in intensity.

1496. By November 2007, there were wider Tripartite discussions about contingency measures in which four risk scenarios for the UK financial system were defined. These scenarios included a worsening funding position for the major banks; general deterioration in the UK wholesale funding markets; a retail run on one or multiple UK institutions perceived to be weak; and asset losses / capital erosion for one or multiple UK institutions. The work also sought to identify potential triggers and institutions most likely to be affected. The FSA's step up in intensity with regard to wholesale funding was questioned by the HBOS Chairman. Lord Stevenson told the supervision team during an ARROW meeting on 14 January 2008 that *'he doesn't believe it was helpful having daily* [liquidity] *calls, not within the public interest and would testify at a Treasury Select Committee regarding this'*.

1497. In a write up of that meeting to his CEO, which he copied to the FSA supervision team, the Chairman's defence of the firm's approach went further: *'HBOS has called the recent credit cycles certainly better than any of the UK banks and probably better than any of the world's top 20 banks….bringing in rigorous credit controls on our corporate lending two years ago which resulted in us having virtually no debt we would have liked to have syndicated when the credit crunch came….we are concentrating very hard on the long term issue as to where housing finance fits in our portfolio….*[it] *would…be wholly irresponsible to rush to decisions at the present time….I made the point that while I personally had a prejudice towards lessening our involvement in housing finance/ finding creative ways of financing it differently, a very strong case could be made by shareholders…. that now would be a crazy time to lower our involvement in housing finance'*.

1498. In his response to the Chairman, the supervisory Head of Department fell short of criticising the firm's business model: '*Balance Sheet Risk – our concern here was not a direct criticism of HBOS's strategy or business model. Rather it was focussed more on the potential risk from a general economic/consumer downturn, neither of which have yet to hit credit quality. Whilst we recognise that you know the commercial property market, other markets such as BTL/self cert are untested and hence our thematic focus. We will take on-board your challenge on the positioning of this within the ordering of Arrow risks*'.

(267) 'Survival days' are the number of days that a firm can survive on its liquidity reserves should it be unable to obtain any additional funding.

1499. By the time of the ARROW validation panel in February 2008, although there was a greater focus by the supervision team on the liquidity position of the firm (and to a lesser extent, its underlying asset quality), business as usual supervisory activity continued, including a focus on operating controls, IT systems and TCF.

1500. A key inflection point in terms of market perceptions was on 27 February 2008, when HBOS announced its preliminary results for 2007. As described in Part 2, Section 2.10.3, *'Market perceptions of HBOS in 2008'*, alongside its results HBOS revealed that it was experiencing a number of difficulties.

1501. FSA records indicate that the supervision team was taken by surprise by the market reaction. That said, the team reacted promptly by requiring information from the firm and undertaking a high-level analysis of HBOS's Alt-A holdings, with FSA risk specialists undertaking an assessment of HBOS's valuations (see Section 4.5.5, *Supervision of HBOS's liquidity and Treasury assets in the crisis period*). This analysis led to broader questions and further work within the FSA around debt valuations (that challenge contributed to HBOS increasing its write-downs) and, consequently, the capital adequacy of HBOS.

1502. There was further evidence of FSA challenge in the note of a call with the firm on 4 March 2008 to review its contingency measures in light of the shortening duration of wholesale funding and weaker equity/CDS prices. In this conversation, HBOS's Finance Director referred to a *'corporate…desire not to look as if they are closed'*. In response to this, the manager of the supervision team recorded: *'but given the rest of the market is doing very little I questioned whether this is really such a problem'*.

4.8.3 March 2008 – August 2008

1503. The poor reception of the February 2008 results announcement marked a watershed moment in the market's perception of the vulnerability of HBOS. March 2008 saw a number of significant market events which led to a further tightening of liquidity in financial markets. This was the same month that HBOS experienced a share price shock (see Box 4.11).

1504. By this stage, contingency planning for HBOS and several other firms had intensified significantly within the FSA. Sir Callum and Sir Hector held a series of discussions with their opposite numbers in the major banks at this time to convey the seriousness of the situation and to ask questions about what plans were in place to raise capital.

1505. A Bank of England paper produced in March 2008 examined options for the takeover of the weaker institutions, with focus chiefly on HBOS, A&L and B&B, in the event that funding conditions deteriorated further. Analysis from the time noted that the size of HBOS meant the number of potential suitors was more limited; consequently, options regarding the breaking up of institutions were discussed in the event that a single buyer could not be found.

1506. A contingency planning paper from the HBOS supervision team to members of FSA senior management dated 18 March 2008 highlighted that HBOS's *'vulnerability to a liquidity squeeze has increased significantly. Whilst the position of other major UK lenders has also deteriorated, HBOS as the UK's largest mortgage provider is looking particularly exposed'*. The paper noted that *'if liquidity were to weaken significantly and suddenly relative to other UK banks, it is not clear there is any other response to stabilise the situation other than state intervention'*.

1507. Steps recommended for HBOS if it continued to fund but with slow and steady deterioration in its liability profile included:

- aggressive sell-down of syndicated loan positions;
- restraint in the specialised retail asset sector, especially buy-to-let, where HBOS was still expanding; and
- realignment of the business by management, including encouraging the sale of portfolios.

1508. The paper also included a clear action *'to signal to management that they should be starting the process of realigning the business if funding markets see no sign of short to medium term recovery'.*

Box 4.11: Share price shock, March 2008

Following an unfounded rumour about the Bank of England Governor cancelling a trip to the Middle East due to concerns about HBOS (later denied by the Bank), HBOS's share price fell sharply by 17% on 19 March 2008.

Concern that market abuse might be at play prompted the FSA to launch an investigation into the *'trading in UK financial shares in recent days'.* The FSA issued a statement announcing the investigation, which included a warning on market abuse: *'There has been a series of completely unfounded rumours about UK financial institutions in the London market over the last few days, sometimes accompanied by short-selling. We will not tolerate market participants taking advantage of the current market conditions to commit abuse by spreading false rumours and dealing on the back of them. We remind market participants of the need to take extra care, in this market climate, to adhere to the market code of conduct'.*(268)

Although no reference was made to HBOS, the issuing of such a statement was an unusual step and was indicative of the authorities' awareness of HBOS's vulnerability and the market's increasingly negative perception towards the firm.

Despite HBOS claiming that the cause of the share price shock was due to market abuse based on *'unfounded, vicious rumours',* the FSA's investigation found no clear evidence of market abuse and a statement to this effect was issued in August 2008.(269)

1509. An internal FSA email dated 22 March 2008 noted that, in the short term (i.e. within three months), there was an *'unacceptably high risk'* that HBOS would become illiquid, but that *'it is hard to see any further actions beyond those set out in the* [contingency planning] *paper that FSA can take to reduce that risk or mitigate its consequences.'* In the longer term beyond three months, it noted that actions already being taken to reduce planned mortgage loan book growth were *'far too little … there is a case for much stronger action'.*

1510. While contingency planning (e.g. for a retail run) was being undertaken within the firm, the tone at the top of the organisation was markedly different, particularly from the Chairman, Lord Stevenson, who did not appear to recognise the gravity of the situation.

1511. As part of a series of conversations with the chairmen of major banks, Sir Callum called Lord Stevenson on 17 March 2008 to discuss the seriousness of the situation. The FSA record of this call noted that the HBOS Chairman was *'indignant about our approaches and sensitivity towards*

(268) FSA statement, 19 March 2008 – FSA warns on market abuse: http://www.fsa.gov.uk/library/communication/pr/2008/026.shtml
(269) FSA Press Release: FSA concludes HBOS rumours investigation FSA/PN/086/2008, 1 Aug 2008.

HBOS'. This message was reinforced in a letter sent the following day to Sir Callum, in which Lord Stevenson wrote: *'the bottom line is that without wishing to be the slightest bit complacent, we feel that HBOS in this particularly storm and given its business characteristics is in as safe a harbour as is possible'*.

1512. There is evidence that the FSA made further efforts to impress upon HBOS the gravity of its position, despite the resistance it faced. For example, following Lord Stevenson's letter, the supervision team met HBOS's Finance Director, Mr Ellis, on 2 April 2008 to ensure the FSA and HBOS were aligned. The supervisory Head of Department informed Mr Ellis during this meeting that, while there had been constructive conversations at working level, *'Dennis Stevenson's letter has led to concerns that the Board aren't grasping the severity of the situation'*. Asset growth and strategic sales were also discussed during this meeting. An action was recorded in the minutes for HBOS to put a plan in place for *'possible sales/cessations with communications and phasing'* and for the Board to have considered all these options, prioritised and taken advice.

1513. In a subsequent email to Sir Hector, the FSA CEO the supervisory Head of Department suggested he reinforce the messages delivered to Mr Ellis in a forthcoming call with Mr Hornby. In particular, it was proposed that the following messages should be conveyed: *'Our expectation is that the Board are fully involved in the strategic elements, and operational consequences, of their contingency plans … and that they ensure that management actions are in place to be available to be exercised immediately rather than being dictated by crystallised risk. In this context, we specifically want the Board to consider and prioritise possible asset sales… This work should be assisted by the appointment of Advisors'*. This was despite Mr Ellis informing the FSA the day before that he was *'reluctant to use advisors at the moment, because they are indiscreet and not particularly useful'*.

1514. As well as working directly with HBOS, the FSA also took actions elsewhere. For example, in interview Sir Hector informed the Review that he had spoken to the major banks through the contingency planning period to discourage withdrawal of lending to HBOS. There were also discussions with several major banks regarding the possible acquisition of HBOS.

Box 4.12: Strengthening HBOS's capital position – April 2008 rights issue

The FSA's heightened focus on liquidity led to a growing focus on capital, particularly as there was an increasing belief that solvency issues underpinned the market's liquidity concerns. Capital ratios were considered to be an additional tool as there were limited options available in the short term to address liquidity issues. The capital position of various banks was discussed at a meeting between the FSA and a group of UK bank Chief Executives on the 6 March 2008. While the meeting did not focus primarily on HBOS, the minutes recorded that Sir Hector asked: *'if we were satisfied that other banks are robust'*. Mr Strachan, MRGD Director, replied that *'we were not yet satisfied about HBOS as there are some questions about valuations'*. The minutes recorded an action to hold a further discussion specifically on HBOS.

On 16 March 2008, a Bank of England paper reviewed the capital needs of the major UK banks. The paper indicated that HBOS would require an additional £6.4 billion in capital to restore its current Core Tier 1 capital ratio, at the end of three years, in the event of a crystallisation of credit losses from a severe and protracted downturn in economic conditions, with a significant fall in house prices. This view was primarily based on concerns about the retail book.

At this time, however, the supervision team did not view capital as a significant issue for HBOS, although there was recognition that this position could deteriorate. A draft FSA contingency planning note of 18 March 2008, which covered four firms including HBOS and had yet to be shared with ExCo, noted that: *'In our view, capital is not the critical issue at this stage, except in the event that write-downs need to be disclosed to the market, thus triggering a loss of confidence.'* The draft paper also set out that, of the four firms, *'this risk is greatest'* for HBOS. A separate paper of the same date on contingency planning for HBOS considered some of the potential risks: *'The immediate risk to capital lies in HBOS's holding of asset backed securities'*.

FSA analysis on UK capital market issues, which subsequently formed part of a presentation to ExCo on 10 April 2008, prompted a member of the FSA senior management team to challenge the supervision team's view of HBOS's capital position on 26 March 2008. This input from senior management appears to have led to a greater appreciation that HBOS could face a capital problem. Separately on 26 March 2008, the Tripartite discussed a Bank of England proposal to refinance the banking system.

In April 2008, a 5% Core Tier 1 target was established by the FSA for the major banks to achieve by December 2008. The rationale was that: *'strengthening capital reduces the threat of insolvency as well as the threat that depositors may withdraw funding due to credit concerns'*.

On 1 April 2008, the supervision team had met Sir Hector and several other members of ExCo to discuss HBOS's capital position. A working paper circulated in advance of the meeting had again played down the need for capital: '*we see funding as the immediate risk facing the firm and the overhang of the ABS revaluation is as much an issue of market confidence as it is of regulatory capital per se*.' However, for the first time, reference was made to the need for the firm to hold adequate levels of core tier one capital. The action from the meeting was for the supervisory Head of Department to speak to HBOS and make clear that *'core tier one below 5% is not acceptable…HBOS should also have full interplay between capital targets, funding and re-evaluations*.' This message was conveyed to the HBOS Finance Director on 3 April 2008.

The capital position of HBOS was discussed again at an FSA Chief Executive Group meeting on 9 April 2008. The minutes noted that: '*HBOS has produced a reasonable plan which leaves minimum core T1 above 5% during 2008'*.

On 18 April 2008, Sir Hector held a conference call with Mr Hornby and Mr Ellis to discuss capital and contingency planning. The FSA CEO noted that, while the FSA was not pressuring the firm to undertake a capital raising exercise, this would be viewed positively as the regulator wanted to be assured that the firm had a credible plan to achieve a strong capital ratio by the end of 2008. He commented that he was content for the firm to work through the process and that the FSA would want to stay close to their thinking. In the same conversation, the HBOS CEO noted that he had already been considering a rights issue. Confirmation that HBOS planned to proceed with a rights issue was seen by the FSA as a *'very good outcome'*.

HBOS subsequently announced a capital raising exercise via a rights issue of £4 billion on 29 April 2008. Based on the probing of HBOS's capital position that had been carried out by the supervision team and other FSA specialists during the contingency planning period, the FSA was satisfied by this figure. FSA records indicate that, before management actions, Core Tier 1 would remain above 5% on a base case assumption, though this figure would fall to 4% on a stressed basis. The base case forecast of Core Tier 1 capital levels by December 2008, after the £4 billion capital raising exercise, was 6.9%.

The FSA's view was also informed by external factors, such as market appetite. In interview, one of HBOS's former corporate brokers, which advised the firm on its capital raising, noted that the £4 billion figure was driven by a number of factors, including the estimated level at which the market expected banks to be capitalised, as well as the market's capacity and appetite.

Further details about HBOS's April 2008 rights issue can be found in Part 2, Section 2.10.3, *'Market perceptions of HBOS in 2008'.*

1515. The Tripartite agreed in mid-March 2008 that *'a specific contingency plan on HBOS would be produced, which the FSA would head up the work stream on'*. FSA records noted a view amongst Tripartite members in late March that *'almost all the actions* [being considered] *risk destabilising* [HBOS]*'.*

1516. The resulting FSA contingency planning paper was sent to the Tripartite Principals (the Chancellor of the Exchequer, the Governor of the Bank of England and the FSA Chairman) on 29 April 2008. The paper considered why HBOS was particularly susceptible to the ongoing market conditions. Notably, HBOS's concentration of exposure to property was seen as a key area of vulnerability, as well as other factors such as large-scale holdings in US mortgage-backed securities and its wholesale funding requirement. The paper also noted some success by the firm in restricting asset growth in Retail and specialised lending areas but that corporate sell downs remained static, with effects taking two to three months to filter through to the balance sheet.

1517. The paper, which set out a number of strands of work that were delivered during the remainder of the contingency planning period, captured input from a number of FSA departments as well as other Tripartite authorities. It was advanced for its time in terms of the range of issues examined and analysis undertaken, which included the FSA's obligations to overseas regulators, Financial Services Compensation Scheme coverage and in-depth reviews of securitisations and ABS portfolios.

1518. The paper also included a communications plan which was designed to identify and propose methods of handling various scenarios, from leaks to speculation that HBOS may be experiencing problems. While the FSA's standard practice at that time was not to comment on specific firms, in light of the run on Northern Rock, the paper considered that there may be certain circumstances that might necessitate the FSA, or other Tripartite members, making a public statement about HBOS for financial stability purposes.

1519. Sir Callum noted during a Tripartite Principals meeting on 30 April that: *'immediate pressures on* [HBOS] *appear to have abated'* and that the firm *'had made strides in its own practical contingency planning'*. An action was agreed to continue to *'develop contingency planning in relation to* [HBOS] *using a worst case scenario'*. When questioned at a separate Tripartite meeting on 30 April what the FSA would do if HBOS encountered a problem at short notice, the FSA said that *'the SLS* [Special Liquidity Scheme] *would be the first port of call and, if that was insufficient, we would speak to the Chairman/CEOs of the other major banks whom we thought would be receptive to providing support. But this would only provide temporary relief'.*

1520. Parallel to the Tripartite discussions, the FSA continued to put pressure on HBOS to consider contingency planning for a retail run, alternative funding plans and other strategic options, such as the sale of portfolios and subsidiaries.

FSA messaging to the Board – a missed opportunity

1521. On 22 April 2008, the FSA issued the letter for the ARROW review work which had been carried out at the end of 2007. The letter had been delayed while the FSA absorbed the implications of the March 2008 share price shock (see Box 4.11), although no mention of this was made in the letter, which recorded the FSA's views as at February 2008.

1522. On 28 May 2008, the supervision team's Head of Department presented the conclusions of the ARROW review to the HBOS Board. This was the only set-piece interaction with the Board during the contingency planning period. The team had last presented to the Board in January 2005, following the December 2004 ARROW, which was not out of line with the FSA's prevailing approach.

1523. During interview, the Head of Department said that the FSA presenting team made *'very pointed comments'* around the concern that the firm appeared to be *'more worried about the franchise risk of withdrawing from the markets than around actually managing the reality of the situation that they were in, which was: 'you really need to curtail lending. You really need to start considering asset sales, and you really need to start thinking through what your contingencies are'.* The Head of Department also commented that it was worrying that the NEDs on the Board, including those that had been brought in with market experience: *'Weren't really showing the degree of concern that they really should have been'.*

1524. While no detailed record of the May 2008 presentation has been found, a summary was written up in a briefing for FSA senior management as well as in the official HBOS minutes. The information available shows that key points made to the Board were that: *'the firm has been slow to contain asset growth, especially in the corporate book … we do not regard the current mix of retail vs. wholesale funding and the shortening maturity profile as sustainable … there are a number of pockets of potential loss (especially in the corporate book) that could cause the firm significant pain'.* Despite the increase in the perceived risk of failure, the presentation does not appear to have been a great departure from a discussion of the main areas of concern set out in the ARROW letter: balance sheet management, liquidity and funding, credit management, TCF and controls. Both the ARROW letter and the presentation were, in retrospect, key opportunities to influence the HBOS Board which the FSA appears to have missed.

1525. HBOS's official minutes of the May Board meeting noted that: *'in some cases (albeit not HBOS) firm's business models were under threat'.* This appears to be a timid description of the internal FSA house view, especially as the FSA was trying to press the firm to take action for survival at this time. For example, an FSA paper of 16 April 2008 stated: '*On a medium to long term basis, HBOS's business model will need to adapt to the changing market conditions… There is no "quick fix" solution for HBOS whilst current market conditions persist… From a strategic perspective, our key primary objective is to continue to ensure the mindset of HBOS management changes – and specifically the Board – to positively consider strategic disposals for survival rather than strategy for growth.*' An FSA internal briefing ahead of a Principals meeting on 15 May also made reference to *'restructuring of the* [HBOS] *business model'* as one of a number of work-streams being pursued by the FSA.

1526. Given that the HBOS Board, in particular, appeared to have been further behind than the FSA in its appreciation of the probability of failure, it is surprising that the FSA did not seize the opportunity during the presentation to emphasise more strongly to the HBOS Board the gravity of its position and to make sure it understood how seriously the Tripartite was taking contingency planning. Indeed, the FSA had recorded an action only a month earlier to discuss contingency planning with the Board: '*Revised business plans for 2008/9 including liquidity, capital and contingency planning will be completed next week. The FSA will be able to discuss these with the Board after the ARROW presentation scheduled for 28th April'*. The minutes of an FSA meeting on 9 April 2008, chaired by Sir Hector, also recorded that the FSA expected *'to have a clear picture of the proposed disposals/running down businesses after the Board meeting at the end of this month'.* While the FSA appearance was delayed by a month and the HBOS Board was yet to sign off formally on the disposal priorities agreed by ExCo, in retrospect it is not clear why the opportunity to discuss contingency planning was not taken.

1527. Although it was standard practice for an FSA Head of Department to lead such a presentation, the FSA would have sent a much stronger message to the HBOS Board about the severity of the environment had it fielded a more senior representative.

A tightening of view

1528. In June 2008, there was a notable change in the FSA's view of the likelihood of HBOS failing as it considered the possibility of a 'fast burn' scenario arising from one of several of the following: the failure of the rights issue; loss of sufficient wholesale market access; and loss of retail confidence. The analysis undertaken also considered potential solutions based on detailed analysis of the information available and their plausibility. For example, a consortium takeover solution was considered less likely to be successful than takeover by a single bank, while liquidity support and/or a form of guarantee were considered the most sensible forms of intervention by the authorities to increase the likelihood of success of a private sector-based solution.

1529. The above change in view coincided with the supervision team's growing concerns about the asset quality of the Corporate lending book. As noted in Section 4.4.3, '*Supervision of asset quality in Corporate*', this led to an in-depth review of Corporate's credit risk controls undertaken by the FSA's risk specialists, which discovered a series of critical issues in July 2008 (see Box 4.6). Despite these concerns, there was little that could be done by this point to alter the characteristics of the Corporate portfolio and prevent the ultimate outcome of the failure of HBOS three months later.

1530. While there were moments of respite in the summer of 2008, work continued at an intense pace on contingency planning for HBOS. Notably, key areas of focus included consideration of options for the sale of HBOS to a single buyer or a consortium; the requirements around the restructuring of HBOS and other firms in the event of nationalisation; and the scope of an HM Treasury guarantee required to stabilise HBOS in the face of a retail run. The summer also saw a number of other events that required the time and attention of the FSA, including the lead up to the rights issue (discussions with HBOS's senior management meant that the FSA knew the take-up would likely be very poor), and market rumours that HBOS was in serious difficulty or that it was being taken over by other banks.

1531. One area where good progress appears to have been made was in relation to retail contingency planning. Following intensive discussions between the FSA and the firm, with input from the Bank of England, the FSA concluded in a letter to HBOS that: '*we are comfortable that due consideration has been given to the main ways in which Halifax and Bank of Scotland could react to a run scenario….the FSA will not require any further action at this stage*'.

1532. However, it is of note that in July 2008, the FSA supervision team commented that: '*we perceive there to have been a distinct change in mindset. The firm appear to have accepted that today's funding environment could exist for a protracted period and they need to adapt their business model accordingly*'. This serves to illustrate the challenge that the FSA faced in pushing its messages to the firm prior to July 2008, only three months before its receipt of ELA.

Box 4.13: HBOS's potential acquisition of Bradford & Bingley

While HBOS was increasingly under stress throughout 2008, the smaller UK mortgage banks had been under more intense pressure earlier on. A notable development through the contingency planning period was Tripartite discussions about HBOS potentially acquiring B&B. Records indicate that this was first discussed between the FSA and HBOS senior management in February 2008. Although the form of the potential acquisition evolved over the period, there is evidence of discussions, at both FSA and Tripartite level, continuing right up to the end of September 2008.

There were two complementary parts to the logic of combining the two entities. First, such an acquisition would help stabilise B&B, thus '[removing] *a weak player in the UK banking sector and therefore eliminate the potential for a contagious failure*'. Secondly, the FSA believed that the acquisition would address HBOS's retail deposit shortfall, and therefore its reliance on wholesale funding, as well as providing HBOS with an expanded customer base and branch network. This is indicative of the degree to which the FSA regarded HBOS's problem as purely one of liquidity, and not one of capital or credit risk.

The FSA did, however, recognise that such an acquisition would be a stretch for HBOS. While it was acknowledged that an acquisition by HBOS was not the optimal outcome, there were limited options on the table at this time. One Tripartite paper noted in June 2008 that: *'While other suitors for* [B&B] *might in theory be preferable to* [HBOS] *there is currently no evidence at this stage of interest from other quarters'*. The paper went on to note that *'the FSA believes that there are clear benefits … and that the purchase of* [B&B] *would, at the margins, improve the financial position of* [HBOS].'

The firm also considered the risks. It informed the FSA in early August 2008 that it would only be interested in a deal if there was a guarantee of funding over an extended period to cover any liabilities arising from the acquisition. HBOS considered that such a guarantee was unobtainable so indicated to the FSA that it had stopped work on a potential deal. Nonetheless, an FSA note from mid-August 2008 recorded that the firm was *'still considering options… They feel they have the best expertise to manage* [B&B's] *asset but to make a transaction acceptable … they need a structure that removes funding risk. They are considering a structure whereby some of the poorer quality assets could be hived off… Alternatively, they are considering how a consortium approach might work, although they have not discussed this with other banks'.*

An FSA briefing note dated 12 September 2008 considered a number of strategic solutions for B&B should events trigger a retail run. A commercial takeover by HBOS (with funding support) was considered the preferred option. However, by 17 September, various events, both in the market more generally and relating to HBOS specifically, meant that a full takeover of B&B by HBOS was no longer feasible. B&B's own circumstances had also changed as it moved closer to failure.

Ahead of an announcement by the government that B&B was to be part nationalised as it no longer met Threshold Conditions, the FSA's ExCo discussed potential bidders for the non-nationalised parts on 28 September 2008. HBOS was considered to be one of only two credible bidders as it *'does help, if not solve, their current liquidity issues'*. Prior to this meeting, the FSA had undertaken calculations to satisfy itself that the partial acquisition of B&B would not have a material negative impact on the bidders' capital and liquidity position.

On the back of these discussions, the FSA sent a paper to HM Treasury setting out a number of issues that it may wish to consider as part of its decision process. Notably, the FSA did not set out a final view on its preferred bidder: *'As the decision is rightly for the HMT we do not see it necessary to provide a conclusive FSA view on the final outcome on the bid process'.*

In relation to HBOS, the paper set out that: *'the additional retail deposits materially improves the net funding position'*. Although, it was acknowledged that: *'it does not however fully address* [HBOS's] *funding requirements over the next 90 days'*. It was also acknowledged that there was a risk the combined entity could be perceived as weaker than HBOS as a standalone entity (given similarities in the two banks in asset mix, liability structure and earnings profile), with attendant impact on HBOS's already volatile funding position.

The paper also included evidence of challenge by the FSA Board in relation to execution risk: *'the FSA board raised a concern that consumers may have a concern of the relative strength of* [HBOS's] *position… However the board accepted that these concerns could be mitigated by appropriate and concise communications to consumers'.*

While the FSA was acting in the interests of financial stability, it is questionable whether the acquisition would have been sensible in practice, particularly as HBOS's position continued to deteriorate. Although the later focus on the possibility of HBOS absorbing the non-nationalised parts of B&B was more appropriate (given HBOS would, in effect, only take on the 'good' liabilities and its funding profile would improve as a result), this was in the context of continued deterioration of HBOS (whereas its position had been viewed as relatively stable in the earlier part of 2008, when the full acquisition of B&B was initially discussed).

The fact that the potential acquisition had been considered for such an extended period of time is also illustrative of the severity of the overall crisis in which decision making was extremely difficult and constrained. Options that would have previously been immediately ruled out came to be regarded as more viable in this situation.

It should also be noted that in the latter months of the contingency planning period, FSA senior management engaged in discussions with the firm as to whether it should merge with other building societies. For example, in a record of a meeting with the firm dated 1 August 2008, Sir Callum noted that '*they* [Lord Stevenson, Mr Hornby and Mr Ellis] *raised the question of whether a HBOS: building society link could be achieved…only a large building society would be suitable. We and they undertook to think about this further'*. This was discussed further with the firm over the course of August 2008. This kind of conversation could have led to some mixed messaging to the firm in terms of how serious the FSA thought the situation was. B&B was ultimately nationalised.

4.8.4 September 2008 – 1 October 2008

1533. By September 2008, the assessed probability of the failure of HBOS had risen notably. A draft briefing paper to the FSA's ExCo from the supervision team, dated 15 September 2008, recorded that: *'It has … for some time been our opinion that* [HBOS's] *current business model is unsustainable in the long-term'.* The team also highlighted that the HBOS Board recognised that significant changes were required to the firm's business model. This change in mindset reflected the content of papers presented to the HBOS Board, which increasingly highlighted the flaws in HBOS's business model from July 2008 onwards (see Part 3, Section 3.5, *Practical illustrations of management, governance and cultural weakness'* for further details). The FSA paper outlined the firm's plans to significantly restructure the business by reining in asset growth on an incremental but material basis, undertaking disposals and reducing reliance on wholesale funding. It also considered the implications and risks arising from the proposed actions suggested to take place over a period of four years.

1534. The FSA's initial assessment considered the plans, on balance, to be credible in significantly reducing the risk posed by the firm to financial stability, provided the market conditions did not deteriorate further and subject to further work especially around capital stresses. It therefore recommended giving the firm time to implement the changes. It also cautioned against more aggressive proposals for fear of damaging the already brittle market perceptions of HBOS: *'for instance, a 'fire sale' of assets poses clear risks to the firm and to financial stability in a fractious and febrile market place. To cease writing assets completely … is likely to damage the* [HBOS] *franchise … any plan that essentially puts* [HBOS] *into (temporary) run should thus be avoided'*. The paper concluded that *'the firm would be ill advised to attempt to make more radical change, or implement plans in a shorter timescale. The balance of market perception has been shown to be sensitive and* [HBOS] *must act with regard for the risk of damaging sentiment and precipitating a crisis'*.

1535. However, the failure of Lehman Brothers on 15 September 2008 was a pivotal point as it became apparent to the market that no bank should be seen as too big to fail. By this stage, HBOS had entered a period of extreme funding stress in which it was experiencing difficulties on a daily basis. HBOS became more reliant on central bank facilities, but this proved increasingly problematic as HBOS continued to exhaust its stocks of eligible collateral (see Section 2.8, *Funding and liquidity*).

1536. On 16 September 2008, following a large fall in its share price, the firm issued a statement that: *'HBOS notes the current volatility in share prices following developments in the United States. HBOS has a strong capital base and continues to fund very satisfactorily'*. HBOS informed the FSA of its intention to issue this statement, which the firm felt would *'have little effect but equally are concerned that silence on their part is damaging'*. HBOS also requested *'a supportive FSA announcement'*.

1537. In a subsequent call with the FSA's General Counsel, HBOS clarified that: *'the statement they would be looking to us to make would be that we were comfortable with their funding position'*. The FSA's General Counsel summarised this conversation in an email to other members of FSA senior management, noting that the firm were trying to counter rumours that they were having funding difficulties by emphasising their retail funding and that they continued to access wholesale markets where appropriate. The FSA's General Counsel added: *'I do not know our view of their funding position, and we clearly could not make this statement if we were not comfortable with it'*.

1538. Having received HBOS's request the day before, the FSA posted the following statement on its website at 9am on 17 September: *'Since the beginning of the current extreme difficulties in the financial markets, the Financial Services Authority has worked intensively with all major UK banks to ensure they have credible capital and liquidity plans. We are satisfied that HBOS is a well-capitalised bank that continues to fund its business in a satisfactory way.'*

1539. At 10am on the same day, HBOS issued a strong request to the FSA to make the above announcement through the RNS system to give the statement more weight. [(270)] HBOS explained the rationale for this to the FSA: *'The situation here is obviously moving very rapidly and in a very grave and serious direction. We strongly would recommend further action by the FSA with the media today to prevent the situation escalating to an extremely serious level. We need to protect the very basic stability of our franchise given the precipitous share price declines this morning and the incessant media coverage. All of these factors combined are making our customers extremely nervous. As you can imagine, a lot of the enquiries are about the safety of their deposits; these have increased very dramatically indeed. The media are no longer listening'*. Although records indicate that Sir Callum initially did not plan to take forward this request, the FSA subsequently issued an RNS statement later that day.

1540. While there were email discussions about the firm's request, the Review did not find any evidence of this decision being taken through the FSA's governance framework. Sir Hector noted during interview that checks had been made with the supervisory and legal teams that the firm had not breached regulatory limits, that the statements were true relative to statutory requirements and that the legal basis for making this statement was sound. While problems of

(270) RNS is a regulatory and financial communications channel for companies to undertake external communications / announcements.

asset quality were emerging in the Corporate book, the full extent of the risks was not clear to the FSA at the time.

1541. Evidence has been found of an assessment of HBOS's capital and liquidity position conducted on the evening of that day, which indicated that the firm continued to meet regulatory requirements. However, the paper also noted that HBOS had *'breached its required Stock Liquidity Ratio (100%) as a result of deposit outflows as reported to the FSA at close of business 17th September'*. Although this information was not available at the time the statement was issued, and while the Stock Liquidity Ratio (SLR) was guidance and not a rule (so did not indicate a breach of regulatory requirements), it was a key indicator of liquidity pressures. Although the firm still had a stock of primary eligible sterling assets, it was noted that *'were deposit outflows to continue at the levels experienced in recent days, these holdings would be liquidated within a matter of days assuming no improvement in access to wholesale markets or further Bank of England facilities'*.

1542. This judgement was taken during a period of high stress, characterised by many critical events each day and grave concern for the stability of the UK financial systems as a whole. Having been notified by HBOS that it was losing deposits through loss of confidence, the FSA decided on balance that an RNS statement would be beneficial to the situation, given that confidence was a key factor in maintaining bank stability. Given the FSA was clearly aware that HBOS faced liquidity pressures, both at that time and going forward, it would have been less of a risk to the FSA not to offer judgements at this point.

1543. On 18 September 2008, the merger of Lloyds TSB and HBOS was announced. While HBOS's position stabilised temporarily, the short to medium-term market consensus was on balance negative, with brokers citing concerns around the effect of HBOS's poorer quality loan book and balance sheet on the enlarged Lloyds Banking Group, as well as the larger quantum of funding required. HBOS's share price experienced a temporary spike of 17%, while Lloyds TSB' share price fell by 15%.

1544. HBOS' funding position continued to deteriorate consistently over the next two weeks. There was recognition by the authorities of the need to *'plan consciously what to do* [to] *not end up in ELA emergency nationalisation position in several weeks' time'*. Nonetheless, the position deteriorated further such that ELA was provided to HBOS by the Bank of England on 1 October 2008 to ensure that it did not default on its liabilities and enter insolvency.

4.8.5 Was there more the FSA could have done during the contingency planning period to prevent the failure of HBOS?

1545. The FSA clearly shifted gears during this volatile period and the nature of the FSA's work was often relentless as it tried to contain the consequences of the financial crisis, not just in relation to HBOS, but for multiple firms that were at risk of failure.

1546. Overall, it is questionable whether any steps that the firm or the FSA could have taken during the contingency planning period would have fundamentally changed the outcome of failure.

1547. First, any actions that were visible to the market (for example, paying a significantly higher price for funding or fire sales of assets) could have caused more negative sentiment towards HBOS, thereby accelerating failure. The firm was certainly very concerned about this – a sentiment shared by the Tripartite authorities. This constrained the number of options available to the firm and the FSA in the contingency planning period. Indeed, the market rumours incident in March 2008 highlighted HBOS's vulnerability to market gossip and evidence shows that it was viewed as increasingly more vulnerable relative to peers in this period. It is possible that the firm may have emphasised the risk of 'spooking the market' to justify its decision to continue growing the

Corporate book, in circumstances where other firms were exiting the market. However, it is difficult to disentangle this, even with the benefit of hindsight.

1548. Secondly, HBOS's business practices were so deeply embedded, and its controls so poor, that it would have been difficult to extract itself quickly. Given the long-tail nature of many aspects of banking, time is required both for the implementation and realisation of many management actions, such as curbing asset growth. There is also a lag between turning off loan commitments and seeing a reduction in lending.

1549. Early intervention – arguably several years before the contingency planning period – would therefore have been required to fundamentally change the course of events. However, as previous sections note, such an interventionist approach by the regulator was not typical of the time. It would have been much more difficult for the FSA to have 'taken away the punch bowl' in the benign economic environment before 2007. Furthermore, the FSA was not sufficiently sighted on the extent of the risks to justify such action.

1550. Greater action by the FSA, and the firm, in the period from August 2007 to February 2008, such as taking steps to constrain asset growth in Corporate and International, could have helped to reduce the cost of failure. However, the FSA did not take such action.

1551. The firm had set up its own contingency planning group which put in place a range of measures. Many of these actions seemed reasonable, particularly within the context of what was seen, at that point, to be a temporary dislocation in the financial markets. The firm had also bought itself more time by obtaining twelve and thirteen month wholesale funding in August and September 2007 although its impending maturity a year later contributed to the insurmountable funding challenge that the firm was facing by the point of failure.

1552. Even after the failure of Northern Rock, the regulatory environment was less intensive than by today's standards, particularly the focus on firms' business models. This is demonstrated by comments made by Sir Hector in a meeting between the FSA and bank CEOs in October 2007. The minutes of the meeting recorded Sir Hector as saying that he would question '*whether the FSA adequately challenged the Board of Northern Rock to ensure that the Board understood the limitations of the business model and understood the risks*', but that '*the FSA would not have stopped Northern Rock using the business model; it is important for competition to shape the market. Firms need a credible long-term strategy to meet our threshold conditions*'. Indeed, the bullish tone from Lord Stevenson during this period also made the job of the FSA more difficult.

1553. Against this backdrop, the FSA would have needed to have started from a position of greater knowledge to have challenged the firm's plans more strongly. Such action would also have required much greater involvement of FSA senior management. While there had been a step up in senior management involvement in the supervision of HBOS from September 2007, their attention in the first half of the contingency planning period was focused chiefly on other institutions, such as B&B and A&L, which were considered to be more vulnerable. Given the bigger impact of HBOS failing, it would have been prudent for the FSA to have focused on it earlier.

1554. The FSA was playing catch up after the onset of the financial crisis as it was not fully sighted on many risky aspects of HBOS's lending portfolios or weaknesses in the overall control framework. There is also broad consensus that the scale and severity of the crisis of the financial system and its impact had not been foreseen collectively. As a result, the FSA underestimated the scale of the risks faced by HBOS.

1555. Another relevant factor was the extent to which inadequate data hampered the contingency planning work of the authorities. For example, the FSA returns completed by firms at the time did not always capture the key information required. Further, from a firm's perspective, additional data being requested could not always be produced given poor IT and systems; it has been noted that this was the case for HBOS.

1556. Some of the actions taken by HBOS management during this period, such as the summer 2008 rights issue, had mixed results and arguably contributed to ever greater concerns about the firm. While the market was not convinced by the narrative put forward by the firm (as reflected in the low take up of the rights issue), it was a reasonable course to take at the time.

1557. There was a step up in the intensity of the FSA's contingency planning work for HBOS from March 2008 following a number of significant market events. However, given HBOS was slower to realise the extent to which its business model needed to change, there were in retrospect some missed opportunities to press the firm harder, in particular during the ARROW presentation to the Board.

1558. Nonetheless, the FSA took many actions during this period, some of which were advanced for the time, including the mandate for the largest banks to have a minimum Core Tier 1 ratio of 5% and the detailed contingency planning paper. Alongside the SLS, these actions arguably prolonged the survival period of the firm. They bought the firm more time and enabled the authorities to undertake more extensive planning. They also enabled a more orderly resolution. Ultimately, however, the recovery options on the table during this period were limited and the actions taken proved to be too little, too late to change the outcome of failure as the market gave the firm insufficient time to adjust its business model.

Appendices

Appendix 1: Review Period, scope and processes followed

Review Period and scope

1. The Review Period for this Report starts on 1 January 2005 and ends on 1 October 2008. Where relevant, key events have been summarised prior to and after the formal Review Period in order to provide important context.

2. On 1 October 2008, HBOS was approaching a point at which it was no longer able to meet its liabilities as they fell due and so sought Emergency Liquidity Assistance (ELA) from the Bank of England. Defining this as the point of 'failure' of HBOS for the purposes of this Report is consistent with the approach adopted for *The RBS Review*.(271)

3. There are a number of different definitions of bank failure. This Report has been written because HBOS was in receipt of extraordinary public support, in the form of ELA from the Bank of England and support from the UK taxpayer, without which it would not have remained solvent.

4. We define the receipt of ELA as the point of failure of HBOS, since without that measure the bank would not have been able to continue trading. However, that is not to state that it failed on this date in a strictly regulatory sense. This was set out in the *Plenderleith Report*(272):

   - *'Para 163: In regard to the second of the three criteria—solvency and viability—**at the point at which ELA was extended HBOS and RBS were both solvent in the regulatory sense that they continued to meet threshold conditions for continuing to operate set by the FSA**. But the extreme level of financial market stress and the specific problems those banks were having funding themselves in the market may have called into question their medium-term viability and therefore future solvency. Further, the deteriorating macroeconomic backdrop inevitably meant there was uncertainty about the quality of the banks' assets and therefore their future solvency.*

   - *Para 164: Despite those uncertainties, there was for both banks a concrete path to future solvency on which the Bank could base its decision to extend ELA. In HBOS's case, the path to future solvency at the point ELA was extended appeared to be the merger with Lloyds TSB that had been announced on 18 September 2008….. In the event, all three of RBS, HBOS and Lloyds TSB were recapitalised significantly.*

   - *Para 166: **Following recapitalisation and the introduction of the CGS** (Credit Guarantee Scheme), **HBOS began sizeable repayments of the ELA facility on 11 December 2008 and had repaid the facility in full by 16 January 2009.** Some of the mortgage collateral that had been used as security against the ELA facility was utilised to increase borrowings from the SLS. This was possible both because during the period of the ELA HBOS had time to securitise assets so that they were eligible for the SLS, and also because, once the merger with Lloyds TSB had been approved, the Bank allowed HBOS greater access to the SLS. HBOS's drawings under the SLS approximately doubled in the second half of January 2009. HBOS's improved ability to fund itself both in the market and through Bank facilities was also supported by CGS issuance. At end-December 2009, Lloyds Banking Group had issued around £50 billion of debt guaranteed under the CGS.'*

(271) *The failure of the Royal Bank of Scotland, Financial Services Authority Board Report*.
(272) *Plenderleith Report*, October 2012.

5. HBOS's failure imposed significant costs on British taxpayers and the failure was a key event in the wider crisis of the UK financial system. There is a strong public interest in understanding what occurred and who was responsible. In accordance with the Review's Terms of Reference, set out in full in Appendix 2, this Report aims to:

- explain and describe why HBOS failed and the FSA's supervision of HBOS;
- inform a wider understanding of the causes of failure during the financial crisis; and
- make any recommendations arising out of the events described in this Report that have not previously been covered by the Financial Services Act 2012(273), the Parliamentary Commission on Banking Standards' report on *Changing Banking for Good*(274) or the Financial Services (Banking Reform) Act 2013.

6. The Report includes a high level analysis of the balance sheets of the Bank of Scotland and Halifax during 1998 – 2001 and of the merged HBOS balance sheet in 2001–2008, focusing on key prudential indicators such as capital and leverage ratios.

7. The Report also examines the quality of the HBOS loan book, considering both what was known before October 2008 and what subsequently came to light.

8. There are a number of areas that have been explicitly excluded as immaterial as activity in these areas did not significantly contribute to the failure of the Group. These are:

- the Insurance and Investment Division of HBOS and its joint venture arrangement with Sainsbury's Bank;(275)
- conduct-related initiatives such as 'Treating Customers Fairly', though these areas are alluded to at key points when they impacted on prudential supervision;
- the role of the FSA's Markets Division and UK Listing Authority; and
- the particular circumstances of the acquisition of HBOS by Lloyds TSB plc.

9. It should also be noted that, consistent with *The RBS Report*, this Report does not consider the effectiveness of the other Tripartite authorities in the period before HBOS's failure.(276) Nor does it consider the effectiveness of the actions which the Tripartite authorities took in response to HBOS's failure and to the wider financial crisis in autumn 2008.

Report production process, responsibilities and quality assurance

10. The FSA Board commissioned the review into the failure of HBOS in September 2012.(277) This followed the conclusion of the relevant enforcement actions regarding the oversight of HBOS's Corporate Division. Prior to this, the FSA considered that it would not have been appropriate to launch a review, as to do so would have risked prejudicing the outcome of those enforcement actions.

(273) The Financial Services Act 2012 gave effect to the changes to the regulatory regime which replaced the Financial Services Authority (FSA) with the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA).
(274) http://www.publications.parliament.uk/pa/jt201314/jtselect/jtpcbs/27/2702.htm
(275) Not to be confused with the joint venture business in HBOS Corporate Division.
(276) The 'Tripartite' was the FSA, the Bank of England and HM Treasury.
(277) Mr John Griffith-Jones, a member of the FSA Board from September 2012 and Chairman of the FCA from Legal Cutover, did not participate in FSA/FCA Board discussions about the Report because he was a partner of KPMG, HBOS's auditor, during the Review Period.

11. At the September 2012 FSA Board meeting, it was agreed that a sub-committee of the FSA Board, chaired by Sir Brian Pomeroy,[278] would on behalf of the Board provide oversight of the production of the Report. Following Legal Cutover[279] on 1 April 2013, oversight of the Report transferred to a sub-group of Non-Executive Directors (NEDs) of the FCA Board.[280] The Report refers to events that took place prior to the existence of the PRA. However, given that the subject matter of the Report is mainly prudential in nature, and because the team undertaking the majority of the work comprised PRA staff, the PRA Board agreed on 22 November 2013 that the Report should be published jointly by both regulators. As a consequence, the sub-group of the FCA Board was amended in February 2014 to become a Steering Committee of both the FCA and PRA Boards.[281]

12. The Review was well-advanced by this stage with much of the work already completed. On 7 July 2014 the PRA Board delegated authority for approval of the Report to Mr Andrew Bailey (Deputy Governor of the Bank of England and Chief Executive of the PRA) and Mr Charles Randell (PRA Independent Director). Both Mr Bailey and Mr Randell have been closely involved in the Report through the Steering Committee.

13. The Report has been produced under the overall leadership of Mr Bailey. The main body of work has been undertaken by a separate Review Team, independent of the day-to-day supervisory functions of the PRA and FCA, led by the Head of the PRA's Supervisory Oversight Function.

14. The FSA Board agreed that a third party, Grant Thornton[282], should be commissioned to conduct an assessment of the management, governance and culture at HBOS. Their analysis supports Part 3 of the Report over which the Review had final authorship

15. Following discussions between the FSA and the Treasury Select Committee, three independent reviewers – Sir Nicholas Monck, Mr Stuart Bernau and Mr Iain Cornish[283] – were appointed in February 2013. Sir Nicholas Monck had to stand down shortly after his appointment due to ill health. The independent reviewers will report to the Treasury Select Committee in accordance with their Terms of Reference.[284]

16. After further discussions between the PRA, FCA and Treasury Select Committee, an independent author – Mr Andrew Green QC – was instructed in December 2013 to conduct a review of the enforcement action taken by the FSA, which forms a separate report.[285]

17. All parties potentially criticised in the Report have had an opportunity to review those potential criticisms as part of process known as 'Maxwellisation'. This is a legally required procedure designed to ensure fairness by providing an opportunity for those parties (individuals or companies) to see a draft of the potential criticisms and to submit representations about their accuracy or fairness.

18. The relevant legislation requires the FCA and the PRA to seek the consent of Lloyds Banking Group, other entities and certain individuals to use their confidential information in the Report. The FCA and the PRA put in place appropriate processes to seek the necessary consents from those parties.

(278) Sir Brian Pomeroy also chaired the RBS Review sub-committee.
(279) "Legal Cutover" was the date of the establishment of the PRA and FCA, and the date when the FSA ceased to exist.
(280) In addition to Sir Brian Pomeroy, other members of the FCA Board sub-group were Andrew Bailey, Mick McAteer and Amelia Fletcher.
(281) FCA members of the Steering Committee: Sir Brian Pomeroy (Chair) and Amelia Fletcher. PRA members: Andrew Bailey and Charles Randell.
(282) Engaged following standard procurement processes.
(283) Mr Cornish, who was a member of the PRA Board from Legal Cutover until March 2015, did not participate in PRA Board discussions about the Report due to his role as independent reviewer.
(284) Treasury Select Committee Terms of Reference on the Independent Review of the HBOS Report: http://www.parliament.uk/business/committees/committees-a-z/commons-select/treasury-committee/news/-specialists-to-review-fsa-report-into-hbos/
(285) From November 2013, Ms Tracey McDermott and Mr Clive Adamson did not take part in discussions at the FCA Board about this Report having declared conflicts relating to the subject matter of Andrew Green QC's report.

19. The regulators have considered their responsibilities in preparing their Report and have decided not to name staff below the level of Director. In reaching this decision, the regulators took into account the following main factors:

- First, the effective operation of forward-looking, judgement-based regulation is essential for the success of the new regime. It is inevitable in such a system that there will be occasions when events will show that those judgements, with hindsight, were wrong. There are therefore inherent risks in such an approach, which are accepted by the regulators at an institutional level. Senior management, who are responsible for determining the strategy, organisational structure and policies to deliver a judgement-based approach, and for making the most material judgements themselves, accept that those responsibilities carry a degree of personal risk. However, the transmission of such personal risks to more junior staff – were they to operate in the knowledge that they could be publicly exposed should their judgements turn out to be wrong with the benefit of hindsight – is likely to hamper materially their willingness to make difficult calls in conditions of uncertainty. Put simply, judgement-based regulation will fail if staff feel it necessary to adopt defensive (or box-ticking) behaviour in order to protect themselves against personal criticisms which are made with the benefit of hindsight.

- Second, the regulators treat their staff with respect and fairness and are conscious of their duty of care to their employees, which applies to employees' physical and mental well-being. All staff, but junior staff in particular, could reasonably expect the regulators to offer them protection from an unreasonable or unjustified degree of stress. Failure to do so could have very damaging consequences for the individual member of staff and their family. The regulators want to avoid this for a variety of reasons – not breaching the duty of care from a legal perspective, but also providing staff, particularly those at a more junior level, with the reassurance that responsibility for actions primarily lies with those directing the organisation rather than those operating within strategies, policies and guidelines set by others. This is consistent with the approach taken by the Parliamentary Commission on Banking Standards, which protected the identity of the supervision Head of Department in its inquiry on HBOS by describing the individual as a 'Financial Services Authority official'.

- Finally, the employer also has a duty to ensure that the implied term of mutual trust and confidence is not breached. The mere act of being associated with actions being investigated within this review could lead to the reputation of staff being unfairly tarnished, which could in turn have implications for their future careers. Any such suggestions in respect of junior staff would be unjustified.

20. The Report was considered and approved by the FCA Board on 5 November 2015 and by Mr Bailey and Mr Randell on behalf of the PRA Board on 12 November 2015.

Appendix 2: Detailed Terms of Reference for the HBOS Review

A report by the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA) into the failure of HBOS plc (HBOS)

1. The Board of the Financial Services Authority (FSA) commissioned a report into the failure of HBOS. It was not appropriate to launch a wider review until the conclusion of certain enforcement proceedings. Those proceedings concluded in September 2012 and the FSA commenced its review of HBOS at that time. As preparation of the Report has spanned the change in the structure of financial services regulation in the UK on 1 April 2013, the Report will be jointly published by the FCA and PRA.

2. The **purpose** of the review is to:

   (a) explain and describe: why HBOS failed; the supervision of HBOS;

   (b) assess the FSA's enforcement investigations following the failure of HBOS, as set out in 4(f) below; and

   (c) inform a wider internal and public understanding of the causes of failure during the crisis (to the extent not already covered by *The RBS report*[286]).

3. (a) The Review **Period** will focus mainly on 1 January 2005 to 1 October 2008, the date when HBOS was in receipt of Emergency Liquidity Assistance (ELA) from the Bank of England.

   (b) For the enforcement section of the Review, the Review Period will be from 1 October 2008 to 12 September 2012, the date of the Final Notice given to Peter Cummings.

4. The Review **scope** will:

   (a) summarise why HBOS failed;

   (b) assess HBOS' capital, asset quality and liquidity positions, as well as systemic vulnerabilities during the period;

   (c) assess management, governance and culture at HBOS at the time;

   (d) assess the key elements of the FSA's supervision of HBOS in the period;

   (e) address the issues set out in paragraphs 141(a) to (g) and (i) in the Parliamentary Commission on Banking Standards' Report into the failure of HBOS[287], paragraph 141(h) being addressed by paragraph 4(f) of these Terms;

   (f) assess the reasonableness of the scope of the FSA's enforcement investigations in relation to the failure of HBOS during the Review Period (i.e. October 2008 to September 2012), including offering an opinion, based on Andrew Green QC's review, as to whether the

(286) Financial Services Authority Board Report entitled *The failure of the Royal Bank of Scotland* December 2011.
(287) Parliamentary Commission on Banking Standards report entitled ''An accident waiting to happen': The failure of HBOS' March 2013.

regulators should consider afresh whether any other former members of HBOS's senior management should be subject to an investigation with a view to prohibition proceedings[288]; and

(g) make any recommendations arising out of the above that have not already been covered in the previous reports, specifically Northern Rock[289], *The Turner Review*[290] and RBS.

5. The report will also include a high level analysis of the balance sheets of the Bank of Scotland and Halifax in 1998 – 2001, and of the merged HBOS balance sheet in 2001 – 2005, focusing on key prudential indicators such as capital and leverage ratios. It will not examine the particular causes and consequences of the Lloyds/HBOS merger itself, but will examine the quality of the HBOS loan book in 2008, considering both what was known before October 2008 and what subsequently came to light.

6. It is anticipated that significant elements of relevant material have already been covered in detail in the RBS report. To the extent this is the case, the report will summarise and refer to this material within this report, which will, nevertheless, be a substantive report and will remain a standalone document.

7. The **approach** and inputs to the review include:

(a) analysis conducted by the FSA Prudential Business Unit/PRA's Supervisory Oversight Function. This function is responsible for reviewing the effectiveness of prudential supervision;

(b) an assessment of management, governance and culture at HBOS supported by an external third party, Grant Thornton; and

(c) placing reliance where appropriate on analysis already published within the RBS report, for example setting out the FSA's approach to supervision in the period.

8. For the enforcement section, the assessment of the reasonableness of the FSA's enforcement investigations will be carried out by a team of independent Counsel led by Andrew Green QC, who will be the author of this part of the report.

9. **Oversight** is provided by a dedicated steering committee comprising Board members of the PRA and FCA respectively. Separately, external independent reviewers have been agreed with the Treasury Committee[291] to review the first four sections of the Report (but not the enforcement section, which is being prepared separately). This approach will provide independent scrutiny and challenge to facilitate the production of a robust report.

10. **Clearance and publication**. The aim is to publish the final report by the end of this year. This timescale incorporates the time needed by the external independent reviewers to complete their review, for Counsel to conduct their enforcement review and the Maxwellisation process, whereby the firm and any individuals subject to potential criticism are given an opportunity to make representations in response to the review's proposed findings. As the report will draw heavily on confidential information previously provided by HBOS and other relevant parties, their consent will also be legally required before publication of this information.

(288) Thus addressing paragraph 141(h) of the PCBS report.
(289) Financial Services Authority report entitled 'The supervision of Northern Rock: a lessons learned review' March 2008.
(290) Financial Services Authority report entitled 'The Turner Review: A regulatory response to the global banking crisis' March 2009.
(291) http://www.parliament.uk/business/committees/committees-a-z/commons-select/treasury-committee/news/-specialists-to-review-fsa-report-into-hbos/

11. The Financial Services Act 2012 (FSA 2012) established the **future arrangements** for investigating regulatory failures. Under this approach, Her Majesty's Treasury will decide whether a firm failure is of a scale and nature which justifies the production of a public report, if the regulator has not already independently decided to produce one. The HBOS review is not being undertaken under FSA 2012. Ahead of that system being in place, the FSA's judgement was that the public's legitimate interest in understanding the key drivers of the 2008 financial crisis, would be served effectively by the publication of reports on RBS and HBOS, together with the earlier report which the FSA produced on Northern Rock and *The Turner Review's* report on the overall regulatory system.

Appendix 3: Chronology of key events

Date	HBOS	FSA	Market Events
2001			
10 September	HBOS formed from the merger of Halifax and Bank of Scotland		
2002			
2003			
2004			
January – June		Interim letter issued to HBOS 13 January James Crosby[292] joins FSA's Board of directors. HBOS's ICR increased from 9% to 9.5% (January)	The Basel Committee on Banking Supervision publishes Basel II (June)
July – December	PwC reports the findings from its Skilled Person Report into HBOS's risk management	ARROW visits and panel, with letter issued to HBOS on 21 December. HBOS's ICR reduced back to 9% from 9.5% (December) Start of Basel II visits to review HBOS models. There are 14 principal visits by the end of 2007.	
2005			
1 January		**Start of Review Period**	
1 January	Appointment of Director of Group Risk – Jo Dawson		
January		FSA asks Corporate to undertake stress testing of its property lending, including to test the resilience of HBOS as a whole.	
February		FSA visits HBOS Australia	
2 March	HBOS announces profit before tax of £4.6 billion for 2004		
16 March	BOSI announces the purchase of 54 retail outlets from ESB to form the basis of branch network in Ireland. The branches will be rolled out from the end of the year.		
July	Appointment of COO – Andy Hornby Appointment of Deputy CEO of Corporate – Peter Cummings		
22 November	HBOS Board approves the Group Business Plan 2006 – 2010		
November		FSA receives the results of HBOS's property stress testing. The firm is advised in July 2006 that no further action is required.	
December	HBOS commences 100 day turnaround programme to remedy issues identified by the FSA with its Basel models		
2006			
1 January	Appointment of CEO of Corporate – Peter Cummings		
5 January	Announcement of Andy Hornby's promotion to Group CEO (effective 31 July)		
1 March	HBOS announces profit before tax of £4.8 billion for 2005		
March	Appointment of new Group Risk Director – Dan Watkins		

(292) James Crosby became Sir James Crosby in June 2006 but relinquished this title in June 2013.

Date	HBOS	FSA	Market Events
Spring		Supervision team undertakes a C&C challenge initiative to reduce the number of RMPs	
		FSA visits Bank of Scotland (Ireland)	
April		Change of supervision team manager	
May	Appointment of CEO of Retail – Benny Higgins	Thematic Review[293] of PPI	
		Thematic Review of Stress testing	
5/6 June	ExCo decides that growth should be increased in targeted areas, including Corporate		
29 June		Interim ARROW letter sent to HBOS.	
July - September		Thematic review of quality of mortgage advice.	
28 November	HBOS Board approves the Group Business Plan 2007 – 2011	Thematic Review of Customer Indebtedness	
December	HBOS submits its application to use Basel II models (six months later than initially planned)		
2007			
28 Feb	HBOS announces profit before tax of £5.7 billion for 2006.		
March		FSA visits HBOS Australia	
April		Supervision team manager leaves. The team's lead associate is appointed acting manager.	First signs of stress in the US sub-prime market.
17 April		The FSA's Risk Committee discusses developments in US sub-prime market.	
17 May		FSA ExCo discusses the possibility of a credit crisis.	
May	Appointment to HBOS Board – John Mack	DMC approves Basel II operational risk models.	
21 June			Near collapse of two hedge funds managed by Bear Sterns.
June	HBOS ExCo increases profit growth targets for Corporate to compensate for Retail underperformance		
26 June		DMC approves Basel II credit risk models for Retail and Treasury but not for Corporate.	
July	BankWest announces plans to develop 160 new branches on the east coast of Australia over the next two years	Thematic review of Liquidity	
July	HBOS commissions a third-party review of GIA		
July – November		FSA undertakes a Pillar 2 review of HBOS	
17 July		The FSA's Risk Committee discusses risks in sub-prime mortgages and hedge funds.	
17 July			Bear Sterns' announcement confirming collapse of hedge funds.
20 July		Change in FSA CEO – Sir Hector Sants[294] replaces John Tiner.	
August		FSA identifies HBOS as one of a number of firms that are particularly vulnerable to market disruption.	
1 August	HBOS's Interim Results for 2007: Group underlying profit before tax up 13% but 8% decline in underlying profit before tax in Retail division.		

(293) Thematic reviews were reviews of an issue across a number of firms, including HBOS.
(294) Hector Sants became Sir Hector Sants in December 2012 and is referred to throughout the Report as Sir Hector.

Date	HBOS	FSA	Market Events
9 August			Short-term money markets freeze; 'crisis period' begins. BNP Paribas announced it had suspended number of funds containing sub-prime investments. The European Central Bank provides €95 billion of liquidity support to the euro area banking market 'to allay fears about a sub-prime credit crunch'.
21 August	HBOS announces the provision of financial support (liquidity) to its ABCP conduit Grampian		
September	Appointment of Group FD – Mike Ellis Appointment of new CEO of Retail – Dan Watkins Appointment of new Group Risk Director – Peter Hickman	The FSA Board discusses deteriorating liquidity conditions. New manager joins the supervision team.	
10 September		DMC approves Basel II credit risk models for Corporate, subject to conditions.	
14 September	HBOS establishes Contingency Planning Group (CPG).		Northern Rock receives Bank of England liquidity support
September	The CPG advises ExCo to begin reducing asset growth.		
October		HBOS's Arrow net probability score is increased to high. The future focus to be on funding and liquidity. HBOS is added to the FSA Watchlist.	
8 November		SREP validation panel ARROW planning panel	
27 November	HBOS Board approves the Group Business Plan 2008 – 2012		
November		HBOS ARROW visits start. FSA Pillar 2 panel agrees HBOS's ICG. HBOS is formally notified on 21 December of the decision.	
5 December		The Tripartite Standing Committee on Financial Stability discusses UK banks' Basel II positions.	
December – February 2008			Several major investment banks announce significant write-downs on structured credit assets.
13 December			The US Federal Reserve coordinates action with five other central banks around the world to inject liquidity in the global banking system.
19 December			Standard and Poor's downgrades or puts on negative outlook major US monoline insurers.
December	HBOS's share price is 26% down on the start of the year.	FSA visits Bank of Scotland (Ireland)	
2008			
1 January	HBOS starts using Basel II models to calculate its capital requirement.		
21 January			Global stock markets, including London's FTSE 100 Index, suffer their biggest falls since 11 September 2001.
26 February		ARROW final validation panel	
27 February	HBOS announces profit before tax of £5.5 billion for 2007.		
End February		Supervision escalates concerns about HBOS's deteriorating liquidity and funding together with weaker share price; this activates Contingency Planning.	
March	The Corporate Board agrees to suspend underwriting except in exceptional circumstances.		Federal Reserve Bank of New York supplies liquidity to Bear Stearns (through JP Morgan Chase) to avert its collapse.
11 March			The Bank of England announces further coordinated action by central banks, extending liquidity support operations by extending repo operations.

Date	HBOS	FSA	Market Events
19 March	HBOS share price drops 17% but recovers some ground. Firm later raises concerns that the share price fall is caused by short sellers and false rumours.		
Mid-March		Tripartite agrees that the FSA will lead on the production of a contingency plan for HBOS	
26 March		FSA publishes report into the failure of Northern Rock; and launches its Supervisory Enhancement Programme	
April		Thematic work on Mortgage Arrears and Repossession Handling The FSA Board discusses and approves the FSA's strategy for major UK banks. The FSA develops a new 5% Core Tier 1 capital regime for the major UK banks	
7 April		FSA Managing Director of Retail Markets (Clive Briault) leaves. The role filled in an acting capacity by FSA Chief Operating Officer.	
21 April			The Bank of England launches Special Liquidity Scheme.
22 April		ARROW letter sent to HBOS	
29 April	HBOS announces capital raising of £4 billion. HBOS draws down on SLS.		
May			Bank of England Forecast – recession within the realms of possibility.
June		Thematic Review of Buy-to-Let lending	
19 June	HBOS's trading update reveals difficulties in its Corporate Division.		
8 – 15 July			Fannie Mae and Freddie Mac share prices fall sharply.
July		Thematic Review of corporate real estate.	
Mid-July			Evidence of deterioration in available wholesale funding maturities for major UK banks.
July		FSA's risk specialists complete their review of Corporate's control framework.	
21 July	HBOS announces 8.29% subscription rate for its £4 billion rights issue.		
31 July	HBOS announces profit before tax of £0.8 billion for the first half of 2008, a fall of 72% on the equivalent period in the prior year.		
August		FSA increases HBOS's overall risk score to the highest possible	
End-August		The FSA starts collecting Liquidity Risk Profile reports from firms	
7 September			Federal Housing Finance Agency (FHFA) announces Fannie Mae and Freddie Mac have been taken into conservatorship.
8 September		New Managing Director of Retail Markets appointed by the FSA – Jon Pain.	
15 September			Lehman Brothers files for Chapter 11 bankruptcy due to losses on US mortgage market. Bank of America announces purchase of Merrill Lynch.
Following collapse of Lehman Brothers			Already impaired liquidity in the interbank markets dries up as banks choose to hoard cash instead of lending it on even short maturities. Firms, including HBOS, experienced the most difficult funding conditions since the crisis period started. Major banks significantly reliant on central bank support.
16 September			Federal Reserve Bank of New York extends liquidity support to AIG; in return the US government takes a 79.9% equity interest in AIG.

Date	HBOS	FSA	Market Events
17 September		FSA issues RNS expressing it is satisfied that HBOS is a well- capitalised bank	
18 September	Lloyds TSB's recommended offer for HBOS is announced		
19 September	OCC restricts HBOS's repatriation of funds to the United Kingdom		
19 September		Change in FSA Chairman – Lord Turner replaces Sir Callum McCarthy	
22 September	Fitch credit ratings agency places HBOS on negative rating watch following announcement of acquisition by Lloyds.		
25 September	HBOS asks to draw down £5 billion SLS in order to settle their position at the end of the day.		Collapse of Washington Mutual, one of the largest US retail banks.
28 September			Belgian, Dutch and Luxembourg Governments announce intention to inject €11.2 billion to shore up Fortis's position, protect the interests of account-holders and help to ensure financial stability.
29 September			UK Government announces guarantee arrangements for Bradford & Bingley plc. Icelandic Government takes 75% stake in country's third-largest bank, Glitnir.
30 September			The Irish Government announces it will guarantee the deposits of Irish banks (this initial announcement did not apply to banks which were part of a UK group).
October		Revised RMP sent to Corporate identifying governance, credit risk management, operating controls and IT systems as high risk areas.	
1 October	The Bank of England provides Emergency Liquidity Assistance to HBOS. The facility is repaid by 16 January 2009.	End of Review Period	
7 October			RBS received ELA from the Bank of England. Landsbanki placed into receivership in Iceland.
8 October	HBOS to receive £11.5 billion in Government support.		UK Government announces its recapitalisation package for banks to increase their Tier 1 capital ratios.
October	HBOS announces sale of BankWest and St Andrews. The sale takes place in December.		
2009			
16 January	Lloyds TSB formally acquires HBOS		
11 February		James Crosby resigns as Deputy Chairman of the FSA	
27 February	HBOS announces a pre-tax loss of £10.8 billion for 2008.		

Appendix 4: Questions from the Parliamentary Commission on Banking Standards

In the report *An Accident Waiting to Happen: The failure of HBOS*, the Parliamentary Commission on Banking Standards (PCBS) asked the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA) to expand on a number of issues identified by the PCBS in its report. Responses to the issues raised by the PCBS are detailed below.

Issue and response

1. *The extent of losses in each division*

Introduction

Before setting out the extent of losses in each division, it is important to understand the underlying drivers of these losses, and the basis on which they have been calculated.

HBOS failed as the financial crisis started to bite. The market knew HBOS was heavily exposed to the fortunes of the property market and in particular that it had high risk commercial property exposures. It did not know the true quality of the HBOS book and therefore the extent to which HBOS was exposed. There was a belief however that HBOS was facing potentially significant losses from the declining economic conditions. This led to a collapse in confidence in the firm and a significant withdrawal of its wholesale funding. HBOS was not capable of continuing as an independent organisation and needed significant public support.

Some individual transactional losses are an inherent part of banking. They arise from the non-repayment of loans in traditional lending to companies and individuals, and from falls in asset values from trading(295) or investment activities. However, if losses become large enough, they can cause the insolvency and failure of a bank.

The majority of the losses reported by HBOS were recognised in accounting periods ending after its failure and as such the recognition of these losses was not the direct cause of its failure. At the point of failure it is not clear that the firm had become insolvent, although it was reaching a point at which it would have been unable to repay its liabilities as they fell due.

The high-risk nature of HBOS's assets in the Corporate and International Divisions made it highly vulnerable to the financial crisis, while insufficient capital and excessive wholesale funding meant it did not have the ability to survive the financial crisis as an independent organisation.

There has also been considerable interest in the losses incurred by HBOS and what they say about its business and the quality of its assets.(296) The PCBS has also asked that this Report '… *shed further light on … the extent of losses in each Division…*'.

(295) Losses can also arise from increasing asset values if a trading strategy involves shorting an asset.
(296) Including numerous representations during the Maxwellisation stage of the Report preparation.

Causes of losses

The magnitude of the losses of any bank is a consequence of the business model of the bank (i.e. its chosen strategy and its lending and investment processes), the stage in the economic cycle and the choices it makes to manage distressed assets.

Losses are typically low, but as the economy moves into the recessionary part of the cycle and assets become distressed, losses rise. The riskiness of its business model determines the extent to which a bank is susceptible to the cyclical swings, and whether and how losses are amplified in the downturn. For example, leveraged commercial property loans are more likely to default than prime residential mortgages, while poor processes(297) can exacerbate the loss by reducing the available options to recover the loans.

A bank's business model should recognise the economic cycle features periods of growth as well as periods of contraction and recession, the susceptibility of its lending strategies to any downturn and it should incorporate actions to mitigate the risks of a downturn. The responsibility for a business model and its vulnerability and resilience to the economic cycle rests with a bank's Board.

A number of options exist to manage an asset when it becomes distressed. A bank may hold on to it in the expectation of a recovery in prices, or it might dispose of it. Continuing to hold an asset is not necessarily a risk free choice. There will be funding costs that need to be covered which may be difficult if the asset is not generating income. There is also no certainty that prices will recover or, if they do, how long that will take. Alternatively, disposing of an asset will crystallise any loss if prices are depressed. A bank will be continually making choices based on the prevailing circumstances as to what is the best option to minimise its overall loss.

The available choices to manage distressed assets can be constrained by weak capital and/or funding positions. Critically, they can lead to a bank losing the ability to control the timing of its recovery strategies. A weak capital position means a firm cannot absorb losses – it becomes insolvent, or a weak funding position means assets need to be disposed of to repay maturing liabilities as they cannot otherwise be refinanced. A bank may therefore not be able to hold its assets through the recession to benefit from the upturn in the economy. It may need to dispose of them towards the bottom of the economic cycle when prices are depressed. A bank can become a forced seller or can be seen as such, putting more downward pressure on prices.

This demonstrates the need for robust stress testing of a bank's business model that explores the interaction of asset quality, capital and funding in a downturn. The PRA and Bank of England have implemented and are further developing a comprehensive stress testing approach to assess the soundness and stability of the UK banking system.

Measures of losses (reported in profit and loss accounts)

There are different measures of loss. This Report has focused on accounting 'impairment losses' recognised in the annual and interim financial statements. They are prepared in accordance with applicable international accounting standards and are independently audited or reviewed. They are the most readily accessible measure of loss as they are publicly reported, and were the subject of additional contemporary reporting to the FSA by HBOS.

Impairment losses are an estimate of an incurred loss when an asset is identified as impaired.(298) The loss represents a permanent fall in the value of an asset. This is either due to non-repayment of a loan (including the failure of any security to compensate for the loss in value), or

(297) For example, if the firm's processes did not perfect the security arrangements on the loan.
(298) Simplistically there is objective evidence that an asset might not be repaid.

from rescheduling the repayments over a longer time horizon such that there is a fall in the economic value of the asset.[299]

This measure is only an estimate rather than the final or actual losses incurred. In 2008 and 2009 considerable uncertainty about the economy meant the range of reasonable estimates could have been wide. As the economy stabilised and improved, and estimates were updated, the accuracy of the estimates should have improved. While the loss for any one year might be subject to a degree of uncertainty, the cumulative loss for the four years to 2011 should be more certain.

The Report also includes accounting 'write-offs'. These are a more final and accurate estimate of loss. Within the accounting framework, assets are written-off sometime after the initial estimate of the impairment loss. There is no standard time within which this happens. The timing of write-offs is determined by a number of factors, including the nature of the asset and the available recovery options. The write-off will occur after all avenues to recover an asset have been explored, or the asset has been disposed of.[300] At this point the loss effectively crystallises. It is typical that the estimate of the impairment loss stabilises some time before the asset is finally written-off, such that there is little further loss (or even gain) to be made. The Report has not primarily used write-offs as the measure of loss as not all assets have yet been written-off, while write-offs have not been reported[301] to the same level of detail as the impairment losses – so providing less information on the underlying assets.

The accounting measure of impairment loss is an incurred loss approach.[302] Losses are only recognised for assets that have already defaulted or otherwise gone bad, and the loss estimate is based on the circumstances prevailing at the point of the assessment. Estimates of future losses are not captured in this assessment. Future losses are either: losses on assets which are considered good but that may default at some point in the future; or an increase in the estimate of loss on a defaulted asset, due for example to a worsening in the economic conditions.

There are other measures of loss that do take into account future losses ('expected loss' approaches). The Basel IRB approach is one example, which calculates an expected loss based on the probability of an asset defaulting within the next year. Alternatively, a 'lifetime expected loss' approach calculates the expected loss based on the asset defaulting at any time during its life. The expected loss model is also an estimate as assumptions need to be made about the future likelihood of loss. It is only when an asset has defaulted and all prospects for recovery have been exhausted that the final real loss can be known.

Theoretically, the expected loss model should report higher losses than the incurred loss model during the boom years of an economic cycle, but lower losses during the downturn, as it takes a longer-term view of the losses in the portfolio and averages them over the cycle.

There are weaknesses in both approaches as measures of risk in a loan portfolio. In a relatively immature loan book insufficient time may have passed for loans to go bad and so, the incurred loss model may understate the risk in the book. Alternatively, the expected loss model is dependent upon making assumptions about the future, many of which are conditioned by, or are models based on past experience. This approach may therefore also understate the loss if the immediate past has appeared to be relatively benign, as it was prior to 2008.

Impairment losses can also arise from falls in the market price of an asset. If the market price falls and does not recover there is effectively a permanent fall in value. This type of loss typically

(299) The application of the time value of money concept.
(300) HBOS's accounting policy was to make write-offs when there was no realistic expectation of recovery.
(301) Whether publicly or to the FSA/PRA.
(302) Following the financial crisis the international accounting standard for impairments will change from 1 January 2018.

affects AFS[(303)] assets held for trading and investment purposes. In the financial crisis certain AFS securities (in particular Asset Backed Securities) were prone to the belief there had been a long-term or permanent fall in value and banks recognised impairments in their financial statements as a consequence. Some of these price falls have subsequently recovered and firms may have potential unrecognised gains.

Losses presented in this Report

The following table sets out the cumulative accounting impairment losses recognised by HBOS in its income statement between 2008 and 2011, as used in this and the PCBS Report. The table reflects impairment losses on loans and securities. It does not include losses arising from trading activities, disposals of business (e.g. sale of BankWest), or fair valuing assets (e.g. certain treasury assets).[(304)] This Report also discloses the cumulative value (£38.8 billion) of loans written-off by HBOS in the period 2008 to 2013.

The losses mainly arose on the assets on HBOS's balance sheet as at October 2008.[(305)] These assets originated as a result of the lending strategies pursued by HBOS senior management in the years prior to 2008.

HBOS prided itself on being a through the cycle lender – i.e. it would have continued lending and would not have sought to dispose of assets during the financial crisis at depressed prices. In 2008, HBOS experienced a withdrawal in its funding amid fears that its capital would not support its potential losses. It failed in the financial crisis as a through the cycle lender.

It is speculation what HBOS's losses might have been under different circumstances – i.e. if assets had been held for longer or disposed of more rapidly. It is impossible to know with certainty, but absent public support and the takeover by Lloyds, it seems entirely plausible that HBOS (under the prevailing Corporate strategy) would have rapidly become insolvent. If HBOS had become insolvent, it would have been valued on a gone concern basis – i.e. its assets would have been valued at the prevailing depressed market rate. It is also likely that any insolvency practitioner would have sought to dispose quickly of assets, potentially at the bottom of the market. The losses could therefore have been far larger than HBOS actually recognised.

Accounting impairments, 2008 to 2011[(a),(b),(c)]

£ billion	Loans and advances	Loss	Loss as a percentage of loans	PCBS Report
Retail	258	6.6	3%	7.0
Corporate	123	21.9	18%	25.0
International	62	15.5	25%	14.5
Treasury	79	6.9	9%	4.6
Other		1.7		0.0
Total		**52.6**		**51.5**
Of which impairment losses on loans		44.7		45.8
Cumulative write offs (less recoveries) of loans between 2008 and 2013		38.8		Not provided

(a) Source: HBOS reporting to the FSA, *Annual Reports and Accounts* and Review calculations.
(b) The impairment loss for Retail, Corporate and International are impairment losses on loans and advances. The impairment loss for Treasury is impairment losses on debt securities. Other impairments are those that the Review has not been able to allocate to a division, as well as 2008 impairments on Corporate's debt securities. It was not possible to allocate all impairments to a particular division due to the nature of the reporting and changes to the divisional structure post acquisition by Lloyds TSB.
(c) Loans and advances for Treasury includes £77 billion of debt securities.

The total losses for both the HBOS and PCBS Reports are per the *Annual Reports and Accounts* for the years ended 31 December 2008 to 2011. The difference is due to a prior year adjustment,

(303) Available for sale assets – typically securities.
(304) See Part 2, Section 2.3.6, '*HBOS's performance post-2008*' for these losses.
(305) With the exception of the Retail Division, HBOS substantively stopped lending after early 2008 – primarily due to its weak funding position.

explained in the HBOS 2010 *Annual Report and Accounts*, that impacted the 2008 reported position, and which was not reflected in the PCBS report.

The divisional breakdown in this Report is based upon contemporary reporting by Lloyds Banking Group (LBG) to the FSA in the period 2008 to 2011 which was not available to the PCBS. This has enabled a more granular analysis of impairment losses, in particular for Corporate and Retail Divisions. Within the relevant sections of this Report, the Retail losses have been further split by product type (e.g. mortgages, secured loans) and the Corporate losses by the sector of the borrower (e.g. construction and property). Overall, this does not produce a result materially different to that in the PCBS Report.

The contemporary reporting was on a 'best endeavours' basis.(306) As a result there is still some judgement in the allocation of impairment losses on securities between the different Divisions. Given the overall magnitude of the losses this is not considered a significant matter to warrant further refinement.

It is not possible to attribute the losses between the financial crisis, the poor quality of the asset, and the choice of recovery strategies pursued post 2008. The losses are the result of the unique combination of events that happened and cannot be disaggregated.

The main points of note in this Report are:

- Not all the £52.6 billion is attributable to high risk lending. The two divisions with the largest proportions of high risk lending in their portfolios were Corporate and International. In aggregate these two divisions recorded £37.4 billion of impairments for the period 2008 to 2011.

- Corporate: the largest losses and the worst loss rates were incurred in respect of the division's property lending (including to hotels and restaurants), in part as this represented the dominant lending of the division, but also due to the high risk features of that lending (e.g. sub-investment grade, high leverage, poor security). However, certain other lending also performed badly with high loss rates, reflecting the poor lending of the division.

- International: as set out in the PCBS Report the Irish businesses (£10.9 billion) contributed the majority of the International losses and had the worst loss rate for the Group overall. Losses (£3.4 billion) and loss rates for Australia were not as bad as Ireland, but were still very poor. As with Corporate, the majority of the losses in both Ireland and Australia arose on very poor commercial real estate lending.

- Treasury: impairment losses have been somewhat reduced by the recovery in asset values which have not yet been recognised in the accounts of HBOS. This Report does not, therefore, consider credit losses within Treasury to have been a significant contributor to overall Group losses. However, the impact of market price falls in 2008 on Treasury assets undeniably contributed to a loss of confidence in the firm at that time.

- Retail: the main losses were incurred on the unsecured book (e.g. credit cards and unsecured loans). While loss rates were higher than some peers, the overall Retail credit losses were not as large as Corporate and International, and are not considered likely to have given rise to a solvency issue for the Group as a whole.

(306) The FSA accepted a potential margin of error. The report was prepared quickly and outside of the FSA's formal reporting obligations for firms. As a result it was not always possible for it to be subject to the same level of scrutiny as a firm's formal reporting to the FSA.

It is difficult to compare losses between different banks as they had different business models coming into the crisis and, therefore, different options and strategies available to them to manage through the financial crisis. Nevertheless, a high-level analysis of loss rates can be said to be a comparison of the aggregate effect of the financial crisis on those different business models. In this regard, a high-level peer comparison suggests HBOS's overall business model was particularly susceptible to the financial crisis.

Section 2.3.6 of Part 2 provides an overall summary of HBOS's losses and compares it to peers. More detailed analysis of each division is to be found in Sections 2.4.9, '*Losses in Corporate Division*'; 2.5.4, '*Losses in International*'; and 2.6.5, '*Losses in Retail Division.*'

2. The decision-making processes within the FSA which led to the effective retreat from a position of warranted close supervision up to the start of 2004

In accordance with its risk-based approach to supervision, the FSA devoted its supervisory resource to those firms that posed the most significant risks to its objectives. Its C&C regime(307) intended for supervision teams to remain close to their firms and consequently the development of their risk profile.

This was the case both prior to and after the start of 2004. However, there was a significant impact on the implementation of this approach over the Review Period as a result of: the degree of reliance placed on firms' senior management and control functions; a significant lack of supervisory and specialist resource; and too much process. The effect was to reduce the level of intensity of supervision.

Prior to 2004 the HBOS Group was still settling down following the merger. From the FSA's perspective, this meant additional time spent understanding the functioning of the new Group and whether its control and risk management functions were adequate for the post-merger strategy.

As the FSA's relationship with, and understanding of the new Group developed, decisions were made to reduce the level of intensity with which the firm was supervised:

- By the end of 2004, the FSA had received assurances (PwC's Skilled Persons Report) that the risk management was generally working well, albeit in need of improvement. The Group also indicated that it was pulling back on its aggressive post-merger growth strategy and had taken action in respect of the FSA's concerns about its significant reliance on wholesale funding. This informed the FSA decision at the December 2004 ARROW validation panel(308) to remove the capital add-on and place greater reliance on senior management and its control functions (see Section 4.3.3).

- As part of the implementation of the new ARROW II approach, FSA senior management launched a divisional initiative in late 2005, aimed at identifying firms that could benefit from a 'regulatory dividend' based on the nature of their relationships with the FSA and the quality of their controls. HBOS was assessed as having both good controls and high levels of openness. This resulted in a number of items being removed from the firm's RMP in mid-2006 (see Section 4.3.8).

The following factors also had a significant impact on the level of intensity of supervision:

(307) In addition to periodic ARROW assessments, there was regular contact with high-impact firms, such as HBOS, through a programme of meetings generally known as 'close and continuous' or 'C&C' supervision. See Section 4.3.5.
(308) See Appendix 10, '*Glossary of main terms*'.

- the sustained political emphasis for the FSA to be 'light touch' and mindful of the UK's competitive position;

- the backdrop of prolonged economic and financial stability which dulled perceptions of risk;

- the unusually high turnover in staff within the supervision team and a reduction (until autumn 2007) in those members with core prudential/banking experience. This made it more difficult for supervisors to identify patterns of behaviour and emerging risks over time;

- the overall supervisory philosophy which did not encourage active investigation in the absence of crystallised risks;

- increasing responsibilities that brought more firms within the scope of regulation without a commensurate increase in resource; and

- an increasing consumer conduct agenda in response to various miss-selling issues (e.g. mortgage endowments, split-capital trusts).

The FSA's overall approach to supervision is considered in more detail in Part 4, Section 4.2, while the supervision of HBOS is covered in Part 4, Sections 4.3 to 4.7.

3. The reasons for the reliance placed on reports commissioned from third parties as to the adequacy of controls within HBOS

This Report considers three reviews requested by the FSA into HBOS's controls. These reviews looked at overall risk management (PwC 2004), Corporate's credit provisioning policy (KPMG 2005) and Group Internal Audit (PwC 2007).

The reasons for obtaining a third-party review included:

- the FSA did not have sufficient or appropriately skilled resources to carry out an investigation;

- using the skills and expertise of third parties, while also bringing a different perspective and providing a degree of objectivity to the findings; and

- the cost of a report was borne by the firm.

Due to the size and nature of HBOS, a comprehensive review of risk management across the Group (looking at the adequacy and appropriateness of the policies, procedures, methodologies, systems and controls) was necessarily going to be wide-ranging and complex. Given the limited resources available at the FSA, the HBOS supervision team decided to commission a Skilled Persons Report from PwC to look at this issue in 2004.

In placing reliance on PwC's 2004 Skilled Persons Report, the FSA had regard to the following:

- The FSA agreed who the skilled person would be (on the basis that they had the necessary skills and experience) and the objectives and scope of the work to be undertaken. The process required the FSA to be informed of emerging issues. Upon completion of the report, the supervision team had access to PwC to discuss and challenge their findings. These measures gave the FSA a degree of control over the process, and acted as a mitigant to the risk that the reviews were not truly independent or limited in scope (e.g. because the firm paid for the work there may have been pressures to temper the findings in anticipation of further work or restrictions on the work to keep the cost down).

- The FSA considered the combination of documentation reviewed, the individuals interviewed and committee meetings observed by PwC appropriate. Although PwC's conclusions were generally positive, their findings were not a complete clean bill of health, and contained a number of warnings: e.g. that the federal structure operated by HBOS could only work effectively if the group oversight function operated in a rigorous and challenging way, but that recent restructures meant it was too early to draw conclusions.[309]

More generally, it is notable that the reports were undertaken by PwC and KPMG, two of the four major UK professional financial services firms. These firms were generally considered in circumstances such as this to have the necessary experience and technical resource to undertake such reviews and benchmark firms against their peers. They also operated under the professional standards of the accountancy profession, including with regard to maintaining independence, managing conflicts of interest and providing internal quality assurance in respect of their work. Both firms also had a history of providing reports to the FSA, including under section 39 of the Banking Act 1987, the predecessor of section 166 of FSMA 2000.

The following sections cover in more detail the FSA's use of section 166 and the two reviews mentioned here:

- the FSA use of s166 FSMA 2000, Skilled Persons Reports: Part 4, Section 4.2.3, Box 4.1, *'FSA use of Skilled Persons Reports';*

- PwC's Skilled Persons Report into Risk Management within HBOS (2004): Part 4, Section 4.7.4, Box 4.9, '*Summary of the scope and main findings of PwC's Skilled Persons Report';*

- KPMG's review of HBOS's collective provisioning policy in Corporate (2005):Appendix 4, PCBS question 4; and

- PwC's review of Group Internal Audit (2007): Part 4, Section 4.7.4, 'S*upervision of Group oversight of controls*'.

It is worth noting that Skilled Persons Reports continue to be used by the PRA and the FCA as a key supervisory tool.

KPMG also undertook a review of Mr Moore's whistleblowing allegations in 2005. The appropriateness of the FSA's actions in respect of this review is considered in detail in Section 4.7.4, Box 4.10, '*Mr Moore's whistleblowing allegations*'.

4. The reasons why the FSA closed the issue of prudence of HBOS's corporate credit provisions

The FSA's December 2004 ARROW[310] letter to HBOS expressed concerns with Corporate's credit provisioning methodology, while noting that the move to International Accounting Standards on 1 January 2005 was going to cause a shift in the balance of provisions from collective to individual. The FSA's RMP[311] required:

- HBOS senior management to set out their plans for updating their provisioning policy;

- HBOS senior management to confirm in writing that they were content with the collective provisioning model, especially in respect of particular aspects of the model set out in a FSA letter dated 14 October 2004 to Mr Mitchell; and

(309) See Part 4, Section 4.7.4, Box 4.9.
(310) See Appendix 10, '*Glossary of main terms*'.
(311) See Appendix 10, '*Glossary of main terms*'.

- Group Financial Risk (GFR), in conjunction with KPMG, to report on the robustness of Corporate's provisioning policy. GFR reviewed the specific or individual credit provisioning policy, while HBOS instructed KPMG to review the collective provisioning policy.

Following PWC's review of HBOS's risk management in 2004, the FSA did not have serious concerns with the competence of Group Risk, which would also have been seen as independent to the Corporate Division.

The RMP action was closed in August 2005 following receipt of the reports from Group Risk and KPMG.

KPMG's overall conclusion was that the collective provisioning policy and methodology produced a result which was consistent in all material respects and appropriately reflected the underlying lending portfolios, given the extent of the available data. Group Risk concluded that the specific provisioning policy and methodology adopted by HBOS also appropriately reflected the underlying business. There is evidence that the FSA reviewed the KPMG and Group Risk reports and clarified that the reviews considered the matters highlighted in the letter to Mr Mitchell.

See Part 4, Sections 4.3.3, paragraph 1185.

5. ***The reasons why the FSA did not undertake serious analysis of the quality of the HBOS loan book in the period from 2005 to 2007***

As set out in response to question 2, the FSA generally reduced the intensity of individual firm supervision if there were no apparent triggers to cause the supervision team to undertaken a detailed review.

The FSA's supervisory approach during the Review Period placed considerable reliance on firms' senior management to manage their firms prudently and involved little detailed assessment of underlying assets during the Review Period. Indeed, the former Chief Executive of the FSA, Mr John Tiner, questioned in interview whether assessments of individual credit files, outside of checks required as part of the Basel framework, were the FSA's responsibility at all: '*It would have been quite exceptional for the credit risk review team to go into individual loan files and make individual assessments. I think that is the job of the board and what we should be checking is that the board are doing that*'.

A supervision team could have undertaken a more substantive review of credit quality if it considered it warranted (e.g. using the s166 process if internal resource was constrained). However, in HBOS's case, certain factors may have contributed to the lack of focus on the quality of HBOS's loan book during this period:

- HBOS was considered to have an open and cooperative relationship with the FSA, providing all information that the supervision team asked for and presenting less challenge to supervisory input and judgement than other similar firms. This was viewed as a potential mitigant to weaknesses.

- As set out in response to question 9, the FSA was aware of many of the risks of the Group's strategy. However, HBOS consistently gave the supervision team assurances that they were confident in the quality of the book and issued strategies, such as the 2005 '*Targeted Growth*' strategy, which claimed to focus on prudent, targeted growth. Similarly, many weaknesses in controls were known to the supervision team (albeit not the full extent of the weaknesses), but management appeared committed through a series of projects to resolving them.

- Basel II implementation was seen as a substantial piece of work that would improve the risk management, credit sanctioning and capital assessment of Corporate's business.

- In the prevailing economic conditions, company insolvencies and difficulties were limited, thus hiding the deterioration in underwriting standards and controls.

See Section 4.4, '*Supervisory approach to asset quality*', for more details.

6. ***The extent to which regulatory decision-making at all levels was influenced by protests of HBOS senior management, including claims about disadvantage to its competitive position***

During the course of this Review, a number of instances have been identified where senior management within HBOS protested against decisions made by the FSA. These protests took a number of forms including letters from Lord Stevenson and Mr Hornby to the FSA Chairman or Chief Executive, letters to the supervision team, or comments made in meetings with the supervision team.

The frequency of the protests increased from 2007 onwards, which is not unexpected given the onset of the financial crisis, the increased intensity of FSA supervision, and the potential magnitude and impact of the decisions and judgements made by the FSA in this period.

The main theme of the protests revolved around Basel II implementation and the capital position of the firm. Any action that suggested an increase in capital requirements was queried or challenged. The general claim was that FSA actions (or inactions in not approving models) were disproportionate and inappropriately contributed to falls in the Group's capital ratios. The concerns expressed by the Group were that HBOS would look inappropriately weaker than it was, leading to a loss of confidence and damage to its franchise, or that the FSA was damaging the competiveness of UK banks (see Section 4.6.3, '*Basel II implementation*').

HBOS was not alone in pushing back on aspects of Basel II implementation. The banking industry in late 2007 generally argued for a relaxation in the treatment of venture capital investments and expected loss deductions. The FSA agreed to modify its rules for both these items allowing firms to present stronger capital ratios (see Section 4.6.3 for further explanation of these issues and the impact on HBOS). More generally, the industry expressed concerns throughout Basel II implementation that it should not be used to increase capital and that UK banks' competitiveness should not be harmed.

On balance, it is not clear that these capital concerns significantly influenced the FSA's decision-making. IRB approval was granted for HBOS, although, this was only after considerably more work had been undertaken by the Group and the property investment model was not permitted to be used. Furthermore, the proposed Individual Capital Guidance (ICG) was not modified and the FSA set a new 5% Core Tier 1 target.

The other main theme was push-back on any expression of significant concern with HBOS's business model or risk profile and inadequacies in its control framework. For example, in an email to the Chairman of the FSA on 13 November 2007, Lord Stevenson noted: '*Can I …have a minor push back?! I and we sense a continual paranoia within the FSA about the "ladder of vulnerability" and HBOS. …I do believe that our management has done enough …over …the last five years … and that there could be some release of the FSA paranoia button!*'

It was not unusual to receive some form of challenge from a regulated firm. However, the relationship with HBOS contrasted greatly to that with RBS, with the latter standing out in terms of the greater regularity and vigour of RBS's pushback to the FSA.

The FSA's regulatory philosophy and approach at the time was deficient (see Part 4, Section 4.2.3, '*The FSA's approach to supervision in the pre-crisis period*'). It included excessive reliance on firms. Overall, in the context of this deficient approach, we have found no evidence that the significant judgements that the FSA made during the period were abnormally influenced by protests from HBOS senior management.

Examples of HBOS challenge to the FSA

The most significant example of protest by HBOS senior management to the FSA during the Review Period concerned the FSA's decision in June 2007 to give HBOS a 'minded to grant' decision in respect of its application for approval to use the Basel II IRB approach, rather than full approval as some other banks had achieved at that point. The 'minded to grant' status reflected the FSA's assessment that HBOS had not yet met the necessary standards to use IRB due to weaknesses in the models within Corporate Division.

Following the decision, Lord Stevenson wrote to the FSA Chairman, Sir Callum McCarthy, to protest and argue that the decision would have severe reputational issues for the firm. At the same time, Mr Hornby called Mr Tiner, FSA CEO, highlighting the commercial implications of the decision and raising concerns about whether HBOS was being treated consistently with its peers. The protests resulted in an internal FSA review of the decision making process. The outcome of this was a letter back to the firm stating that the FSA had followed due process but would be prepared to review the firm's application when it felt in a position to demonstrate progress on the FSA's issues.

HBOS carried out further work on its IRB models in the second half of 2007 and at the end of 2007, the FSA gave permission to HBOS to use its models, although even then this was on the basis of conditions. The FSA also noted that approval was given partly relying on assurances made by HBOS.

There are other examples from the Review Period of HBOS senior management raising concerns over regulatory decisions with the FSA with limited impact:

- In January 2004, Mr George Mitchell's (The Chief Executive of the Corporate Division) response to findings of a number of weaknesses in the management of the commercial property book, following a visit by FSA risk specialist, was to express '*extreme*' disappointment at the tone of the letter and to consider '*many of the comments and findings to be very unfair*'. The FSA's concerns remained.

- In 2005, the FSA required HBOS to stress test its commercial real estate book. This exercise was considered to be unnecessary and *'over the top'* by some members of HBOS senior management. The FSA pressed HBOS to undertake more detailed stress tests as the initial results were not considered to fulfil the brief (see Section 4.4.3).

- In March 2005, following an FSA visit to Australia, Mr Colin Matthew (Chief Executive of the International Division) rejected the findings that Australia was '*dangerously close to running too fast*' as not fully formed, notwithstanding a Group Risk review in late 2004 had reached many similar conclusions. The supervision team followed up its concerns with the CEO, who was felt to be more sympathetic to the issues, and attributed Mr Matthew's response to presentational style and uncertainty how to respond to the FSA (Section 4.4.4).

- In late 2007, there were pleas to the supervision team for recognition that Basel II implementation (and in particular IRB implementation and '*undue conservatism by the FSA*') was having a downward impact on ratios, damaging confidence in UK banks, putting UK banks at a competitive disadvantage and damaging the credibility of Basel. Although the FSA clarified its rules on the treatment of venture capital investments and, the tax treatment on expected loss, in a way that was beneficial to HBOS, this was in response to lobbying on these two issues from the wider UK banking industry (see Section 4.6.3).

- The proposed ICG communicated to the firm in October 2007 represented a reduction in the previous capital guidance given to the Group (Section 4.6.3), and with which the firm was generally happy. While there was no significant challenge, the Group still queried the add-ons, with the FSA asked to justify its methodologies (principally in respect of concentration risk where the firm argued there should be no additional capital add-on) and to ensure that HBOS was treated akin to its peers. The final ICG, communicated to the firm in December 2007, remained unchanged.

- In November 2007, Mr Hornby communicated to the FSA that there was *'a perception gap with the FSA'* around controls and that the FSA's 'Medium High' assessment score was *'not backed up by the numbers'*. This intervention did not result in the FSA changing its assessment (see Section 4.7.3).

- The step up in intensity with regard to the supervision of wholesale funding in the crisis period was questioned by Lord Stevenson, who told the supervision team in January 2008 that *'he didn't believe it was helpful having daily* [liquidity] *calls, not within the public interest and would testify at a Treasury Select Committee regarding this'*. The FSA continued to closely monitor HBOS's liquidity position (see Section 4.8.2).

- Further to the January 2008 meeting, Lord Stevenson sent the FSA a copy of his write-up of the meeting, in which he went further, including claims that HBOS called recent credit cycles better than other banks, had implemented rigorous credit controls and that it would be irresponsible to rush to decisions at the present time. The FSA's response was somewhat defensive: '*Our concern…was not a direct criticism of HBOS' strategy or business model*' (see Section 4.8.2).

- In early 2008, the FSA revised down its capital add-on in relation to Australian exposures remaining on the Basel I methods, from a 25% uplift to a 10% uplift. This was following challenge from the firm which considered the 25% uplift to be a '*wholly unacceptable situation*' (See Section 4.6.3).

- In May 2008 Mr Ellis sent an email to the supervision team expressing surprise at the proposed letter setting out the FSA's new 5% Core Tier 1 target (see Section 4.6.2 and 4.8.3, Box 4.12). He expressed two reasons: the FSA had not previously suggested it would apply super-equivalent (i.e. stricter) standards than Basel, but if it did that it would apply them to all UK financial institutions; and that there could not be any inference that the firm's then capital raising was influenced by a regulatory requirement. This email did not alter the FSA's stance on the Core Tier 1 target.

- In August 2008, Mr Hornby wrote to the FSA to raise concerns about perceived 'over-conservatism' in the FSA's approach to individual models. In this letter, Mr Hornby said: *'Excessive conservatism is neither in the interests of HBOS shareholders nor indeed does it help regulatory stability. It is vital that we take a prudent but more pragmatic approach to the model roll outs'*. This letter did not affect the FSA's approach to models.

7. ***The nature and extent of FSA senior management[312] involvement with HBOS***

Prior to the financial crisis

Prior to the financial crisis, the supervision team primarily led key interactions with the firm, with the manager acting as the main point of contact. The supervision team, with support from FSA specialist teams, dealt with day-to-day issues, such as ARROW and C&C meetings, as well as ad hoc work and thematic analysis.

The FSA's Chairman and executive management had some limited interaction with HBOS. This included periodic group meetings arranged by the FSA with the chief executives or chairmen of several systemically important banks, including HBOS, to discuss market topics as a group. FSA senior management attendance at bilateral meetings with HBOS occurred on an ad-hoc, infrequent basis. In general, both of the firm's Chief Executives were available for the supervision team to meet with them directly.

The supervision framework included some touch points for FSA senior management to validate key supervisory judgements, such as ARROW panels which were chaired by a Director, and presentations of findings from ARROW reviews to the firm's Board which were typically led by the supervision team's Head of Department or Director. FSA senior management were also involved in decisions on whether to approve Basel II waiver applications, which were made at Decision Making Committees (DMC) chaired by an independent Head of Department.

There were also processes for supervision teams to escalate key judgements or exceptional events, for example via the 'Watchlist' or to the FSA's Firms and Markets Committee (FMC). FMC meetings took place on a weekly basis and facilitated information sharing on major regulatory or firm specific issues. FMC members included the FSA Chairman, Chief Executive, Managing Directors and supervisory directors, although alternates often attended in place of members. HBOS issues reported to this Committee during the Review Period included Mr Moore's whistleblowing allegations, key senior management changes at the firm, updates on the development of Corporate's Basel IRB models and various conduct issues.

Although the supervision team escalated some key issues and judgements, FSA senior management were distant from day-to-day supervision, with only fragments of information going to different individuals over the course of the Review Period. Senior management did not provide sufficiently clear direction to front line supervisors, track progress or monitor issues over time. Overall, the level of engagement by FSA senior management prior to the financial crisis was insufficient (see Section 4.3.7).

During the financial crisis

After the onset of the financial crisis, there was an unprecedented level of FSA senior management involvement in the supervision of HBOS. FSA senior management were consistently involved in decision-making on contingency planning issues for HBOS through discussions at ExCo and in Tripartite fora, as well as through the escalation of issues requiring senior management intervention. In addition, FSA senior management, including the Chairman and Chief Executive, had many discussions directly with the firm through this period (see Section 4.8).

8. ***Whether, rather than having their Approved Persons status simply lapse, Lord Stevenson, Sir James Crosby and Andy Hornby (and anyone else presiding over a similar failure in future) should be prohibited from holding a position at any regulated entity in the financial sector***

In accordance with the Terms of Reference (see Appendix 2), part 4 (f) of the scope of the Review sets out that this is to be addressed within the Report produced by Andrew Green QC.

(312) FSA 'senior management' refers to Head of Department level up to Managing Director.

9. ***The extent to which the judgements in the FSA Enforcement Final Notices in respect of HBOS reflect judgements that either were, or should have been, reached by the FSA during the course of their supervision of HBOS.***

The FSA's Enforcement Final Notices made the following judgements:

- HBOS Corporate Division pursued an aggressive growth strategy with a specific focus on high-risk sub-investment grade lending. The division portfolio was high risk, highly concentrated in its exposure to property and to large borrowers, and highly vulnerable to a downturn in the economic cycle.

- There was a culture within Corporate that was strongly focussed on revenue rather than risk-adjusted returns.

- Corporate did not take reasonable care in the management of high-value transactions, which were showing signs of stress.

- There were serious deficiencies in Corporate's control framework, which resulted in an inadequate level of challenge. Despite the known weaknesses in the control framework, Corporate's management continued an aggressive growth strategy.

- There were serious deficiencies in Corporate's management of credit risk.

Supervision always had a high-level knowledge and understanding of some key risks (e.g. the division's growth strategy and the size of its exposure to commercial property) and was aware of some potential/emerging risks. Supervision's understanding of the impact of these known risks developed and deepened over the Review Period. Other risks also became apparent, in part due to actual market reactions to evolving economic conditions (e.g. the slow recognition of impaired high-value transactions in a time of stress). These were later brought together in the judgement in the FSA's Enforcement Final Notice. Supervision was aware of some weaknesses but not all, and certainly not the magnitude of seriousness attributed to the weakness in the FSA's Final Notices.

Supervision had reached conclusions and taken action on some key components of the FSA's Enforcement's judgement, but consistent with its approach at the time, it relied on HBOS Corporate senior management to resolve the identified issues. Such was supervision's relationship with HBOS senior management that assertions made by them that mitigating action had been taken were generally accepted without further verification or testing (see Section 4.3.8). Considerable time was allowed for firms to resolve issues as the FSA did not see its role as taking interim action (e.g. change a firm's permissions to prevent growth) while issues were resolved.

The benign economic conditions dulled the appreciation of the downside risks. This appeared to be reflected in a style of supervision which at times was not sufficiently proactive, intensive or challenging and did not give priority to prudential risk issues.

The onset of the financial crisis led to a step change in the FSA's approach to supervision. A more intrusive approach was applied to prudential supervision. As the financial crisis continued, the increased levels of monitoring and testing by the FSA led to a greater understanding of the potential magnitude of the risks faced by HBOS. It was only following this work that the individual elements were drawn together by supervision (after HBOS' failure) to support the referral to Enforcement.

As for the question of whether these judgements should have been reached during the course of the FSA's supervision of HBOS, regulators now recognise that the areas that were the subject of the Enforcement Final Notices are matters that supervisors should have been looking at.

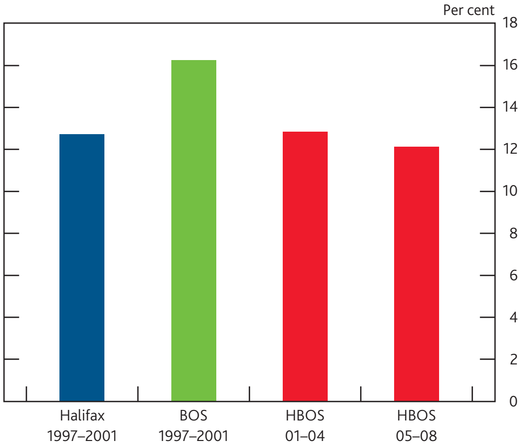
Appendix 5: Comparison of HBOS with Halifax and Bank of Scotland

1. This section gives a high-level comparison of the performance of HBOS with its predecessor institutions – Halifax and Bank of Scotland.

2. In the initial years following the merger, HBOS could be characterised as a weighted average of its two predecessors. This meant that the higher-risk features of the individual predecessors – notably BoS's high loan-to-deposit ratio and low Tier 1 capital ratio and Halifax's higher leverage ratio – were partially offset by the lower-risk features of the other firm. As a result, HBOS initially had a lower risk profile than the individual pre-merger entities.

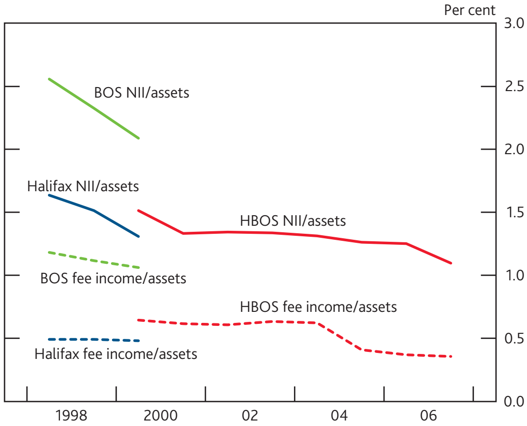
3. Over time some of HBOS's key metrics shifted towards the riskier end of the scale. Most notably, HBOS's wholesale funding as a percentage of liabilities started at a level between BoS and Halifax, but exceeded the levels of both predecessor firms by the end of the Review Period. HBOS's loan-to-deposit ratio followed a similar pattern. As such, on the basis of contemporary data it is fair to conclude that the risk profile of HBOS was by the end higher than that of the pre-merger entities.

Chart A.5.1: Average annual growth rates in assets(a)



(a) Source: *Annual Reports and Accounts* and Review calculations.

Chart A.5.2: Net interest income and fee income yields(a)



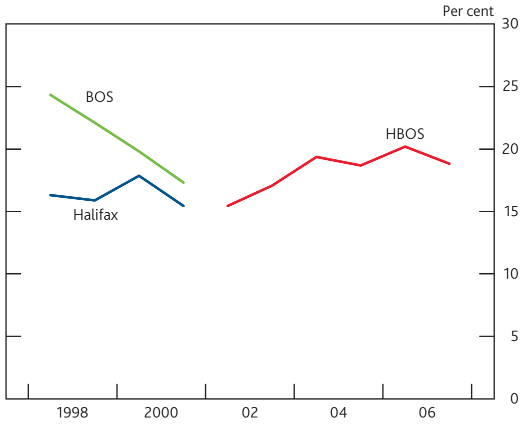
(a) Source: *Annual Reports and Accounts* and Review calculations.

Balance sheet growth and profitability

4. BoS grew faster than Halifax in the four years prior to the merger (Chart A.5.1). After the merger, growth of the new combined Group slowed to below the pre-merger growth rates of both BoS and Halifax, although at 12%, this was still at a significant pace (and considerably ahead of nominal GDP growth). Nevertheless, this did not make the firm an outlier amongst its peers. In the period 2001 to 2004, RBS grew 17% per annum, Barclays 14% and, Nationwide 14%, while Lloyds TSB only grew 6% and Abbey contracted.

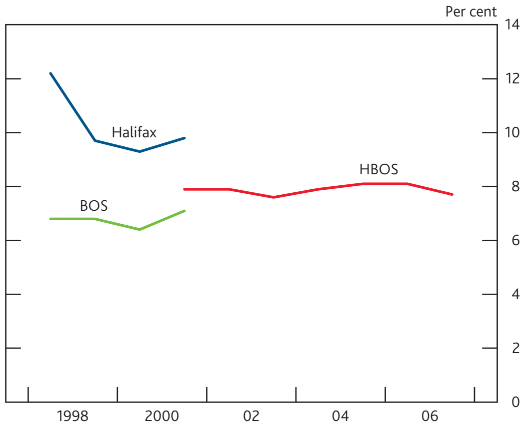
5. Net interest income broadly followed the path of real interest rates, for HBOS and its predecessors, both prior to and immediately after the merger (Chart A.5.2). When real interest rates started falling again from 2003 HBOS was able to keep its net interest margin relatively constant, but this was at the cost of taking on increased risk as the Group grew its higher-risk corporate business relative to its retail mortgage business.

Chart A.5.3: Return on equity[(a)]



(a) Source: *Annual Reports and Accounts* and Review calculations.

Chart A.5.4 : Tier 1 ratio[(a)]



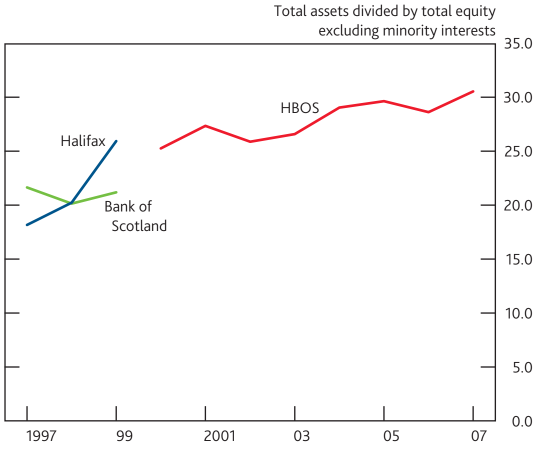
(a) Source: *Annual Reports and Accounts*.

6. Prior to the merger, both Halifax and BoS had suffered from a reduction in their return on assets and return on equity (Chart A.5.3). After the merger, there was an initial improvement in returns for HBOS as result of stabilising yields, the benefits of cost synergies, and more latterly increased leverage and share buybacks.

Capital and leverage

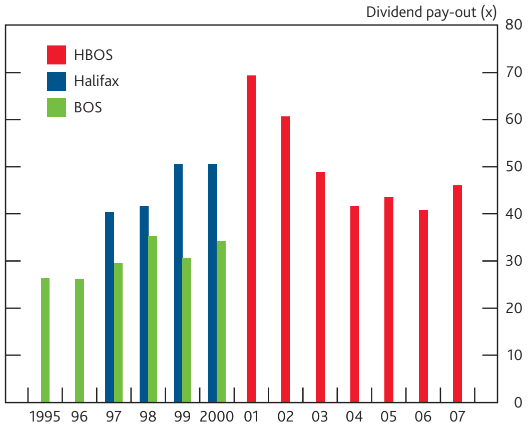
7. HBOS's Tier 1 ratio was around 8% post-merger, broadly speaking a weighted average of Halifax's higher figure (around 10%) and BoS's lower number (around 6-7%) (Chart A.5.4). HBOS's Tier 1 ratio remained at this level until 2008, when it decreased to around 6% as the financial crisis took hold and the more risk sensitive Basel II framework meant it became harder for HBOS to meet its target ratio.

Chart A.5.5: Leverage ratio[(a),(b)]



(a) Source: *Annual Reports and Accounts* and Bank of England calculations.
(b) Leverage ratio defined as total assets divided by total equity excluding minority interest.

Chart A.5.6: Dividend pay-out ratios[(a)]



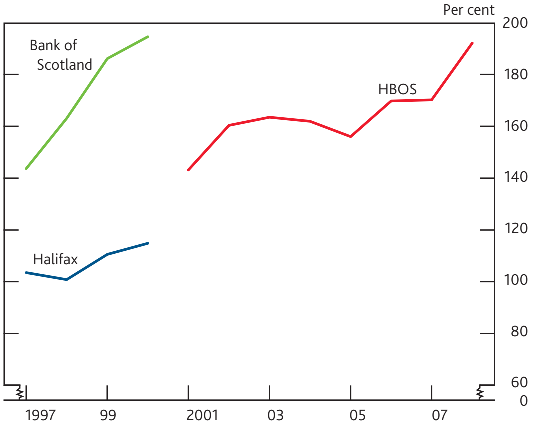
(a) Source: Bloomberg.

8. Halifax's leverage ratio was above that of BoS prior to the merger (Chart A.5.5). This does not suggest that Halifax had a higher level of risk given the different portfolios of the two entities. Whereas BoS had a mix of retail and corporate assets, Halifax mainly had UK retail mortgages (Chart A.5.8), generally perceived as lower risk.

9. Post-merger, HBOS's leverage ratio was closer to that of Halifax, quickly climbing above it before continuing to increase up to the point of failure.

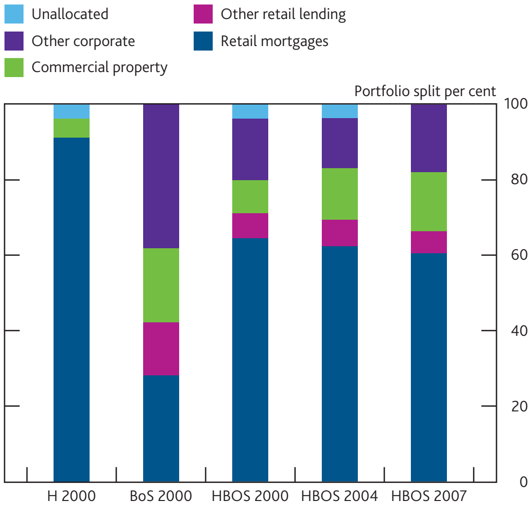
10. The formation of HBOS also saw a shift to a more generous dividend pay-out policy and share buyback scheme, which was initially very high following the merger before stabilising at levels similar to those pursued by Halifax (Chart A.5.6).

Chart A.5.7: Loan-to-customer-deposit ratio[a]



(a) Source: *Annual Reports and Accounts* and Review calculations.

Chart A.5.8: Portfolio composition[a]



(a) Source: *Annual Reports and Accounts* and Review calculations.

Liquidity

11. The loan-to-deposit ratio had been growing in both firms prior to the merger, with BoS's ratio (194%) particularly high given its lack of a strong deposit platform (Chart A.5.7). The HBOS ratio was initially between that of its predecessors (143%), but started to rise strongly, in particular from late 2004, and had reached 170% by the end of 2006.

12. The driver of the growth of the HBOS loan-to-deposit ratio was a decline in deposit growth while asset growth continued to increase strongly. In the immediate aftermath of the merger, HBOS had achieved a stronger deposit growth rate than its predecessors, but over time this fell substantially and was always below the loan growth rate.

13. Prior to the merger, BoS was perceived as having a high dependence on wholesale funding, and its choice of potential merger partners was partly motivated by its desire to reduce this dependency. In practice, this was not achieved as HBOS continued to have a high and increasing reliance on wholesale funding until its failure.

Property exposures

14. Both Halifax and BoS had significant property exposure, albeit they had different mixes of retail and commercial lending reflecting their origins (Chart A.5.8). Halifax was primarily a retail mortgage lender, while BoS had a more balanced mix of retail and commercial lending. The aggregate retail and commercial property exposure of the combined firms was around £112 billion and £15 billion respectively as at the end of 2000. The newly combined HBOS Group reported an increase in these exposures to £131 billion and £21 billion as at the end 2001.

15. By the end of 2007 HBOS had more than doubled its retail mortgage portfolio to over £260 billion. Its commercial property portfolio grew significantly faster, increasing to over £60 billion and leading to a shift towards riskier assets within the overall portfolio mix.[313]

(313) These numbers are based on the annual reports and accounts. As noted in Part 2, Section 2.3.4, it seems likely that the commercial property exposures were higher than reported.

Appendix 6: Summary of HBOS directors' roles and experience

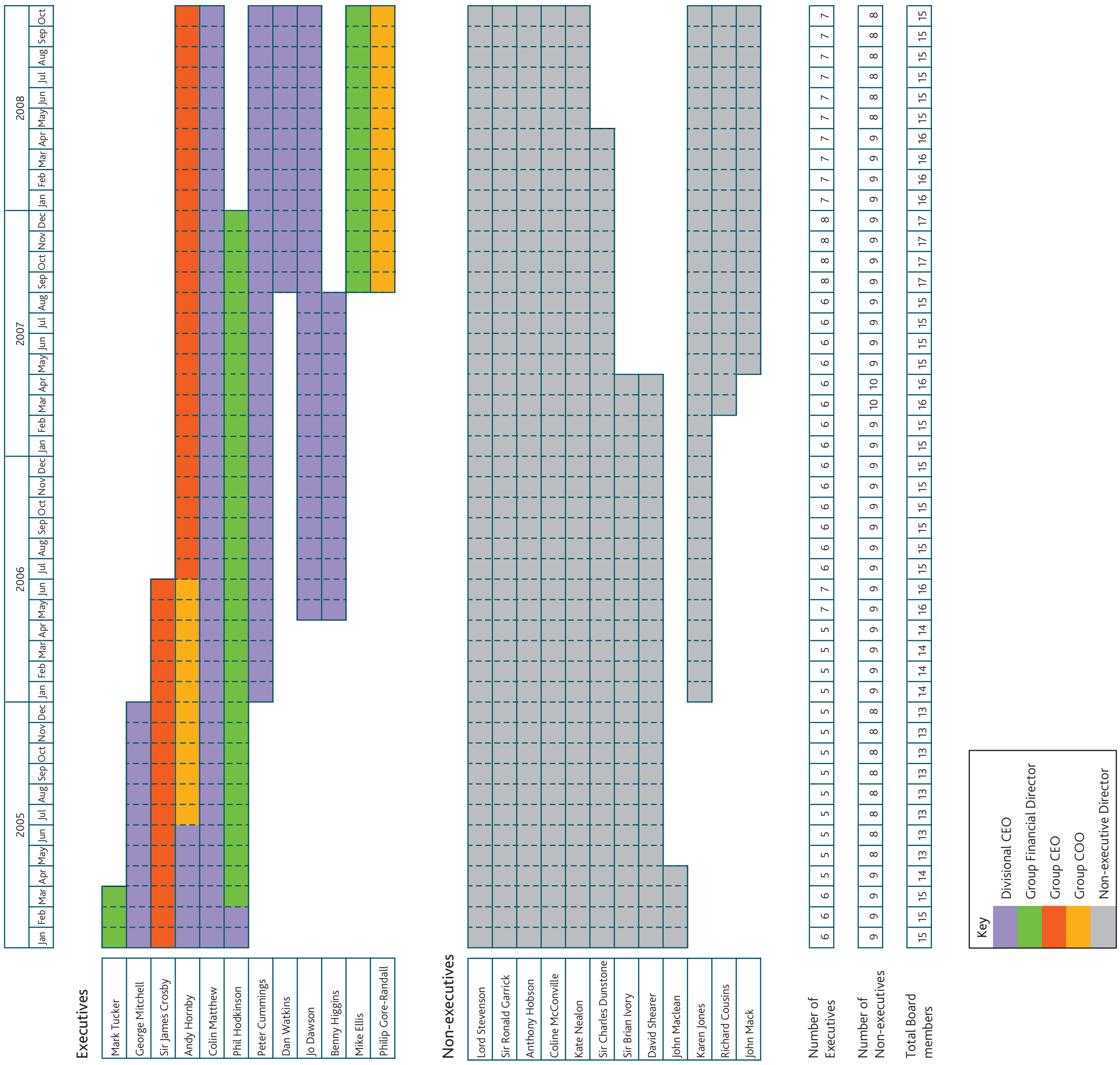
Executive directors

Name	Roles held at HBOS	Professional qualifications	Previous experience
James Crosby	Group CEO (September 2001 – July 2006)	Actuary	Scottish Amicable Life plc, Halifax plc
Peter Cummings	CEO of Corporate (January 2006 – January 2009)	Chartered Institute of Bankers in Scotland, MBA (Strathclyde)	Bank of Scotland employee since leaving school
Jo Dawson	GRD (January 2005 – February 2006) CEO of Insurance and Investment (March 2006 – December 2008) CEO of Retail Distribution (August 2007 – April 2009)	MBA (Warwick)	NatWest Bank plc, Greenflag Ltd
Mike Ellis	GFD (September 2001 – December 2004) and (January 2008 – January 2009)	Chartered Institute of Bankers in Scotland, Accountant – CIPFA	Halifax plc
Philip Gore-Randall	Group COO (September 2007 – April 2009)	Accountant – FSA	Arthur Andersen LLP, AON plc
Benny Higgins	CEO of Retail (May 2006 – August 2007)	Chartered Institute of Bankers in Scotland, Actuary	Standard Life plc, The Royal Bank of Scotland Group plc
Phil Hodkinson	CEO of Insurance and Investment (September 2001 – March 2005) GFD (March 2005 – December 2007)	Chartered Institute of Bankers in Scotland, Actuary	Allied Dunbar plc (subsequently Zurich Insurance Group ltd)
Andy Hornby	CEO of Retail (September 2001 – July 2005) Group COO (July 2005 – June 2006) Group CEO (August 2006 – January 2009)	MBA (Harvard)	Asda Stores Ltd, Blue Circle Industries plc, Boston Consulting Group
Colin Matthew	CEO of Strategy and International (September 2001 – January 2009) CEO of Treasury and Asset Management (March 2007 – January 2009)	Chartered Institute of Bankers in Scotland, MBA	Bank of Scotland employee since leaving school
George Mitchell	CEO of Corporate (September 2001 – December 2005)	Chartered Institute of Bankers in Scotland	Bank of Scotland employee since leaving school
Mark Tucker	GFD (October 2004 – March 2005)	Accountant – ACA	PwC, Prudential Corporation Asia Ltd
Dan Watkins	GRD (March 2006 – September 2007) CEO of Retail Products (September 2007 – April 2009)	–	Morgan Grenfell (subsequently Deutsche Asset Management), Birmingham Midshires Building Society/Halifax plc

Non-executive directors

Name	Roles held at HBOS	Professional qualifications	Previous experience
Richard Cousins	NED (March 2007 – January 2009)	–	Compass Group plc, Cadbury Schweppes plc, BPB plc, BTR plc
Sir Charles Dunstone	NED (September 2001– April 2008)	–	Carphone Warehouse Group plc
Sir Ron Garrick	NED (September 2001 – December 2008) Deputy Chairman (January 2003 – January 2009)	Chartered Engineer	Weir Group plc, Scottish Power UK plc, Shell UK Ltd
Anthony Hobson	NED (September 2001 – December 2008) Chairman of Audit Committee (September 2001 – January 2009)	Accountant – FSA, MBA	Legal & General Group plc
Sir Brian Ivory	NED (September 2001 – April 2007) Chairman of Remuneration Committee (September 2001 – April 2007)	–	Highland Distillers plc, Macallan-Glenlivit plc, The Scottish American Investment Company plc, National Galleries of Scotland (Charity)
Karen Jones	NED (January 2006 – December 2008) Chairman of Remuneration Committee (April 2007 – January 2009)	–	Spirit Group/ Punch Taverns plc, Pelican Group plc (co-founding Café Rouge)
Coline McConville	NED (September 2001 – January 2009)	Lawyer – Australian qualified, MBA (Harvard)	LEK Consulting LLC, McKinsey & Co Inc, Clear Channel Outdoor Holdings Inc
John Mack	NED (May 2007 – January 2009)	MBA	Bank of America LLC, Shinsei Bank Ltd, International Power Group Ltd
John Maclean	NED (September 2001 – April 2005)	Accountant – CA, MBA	Kelvin Shipholdings Limited
Kate Nealon	NED (September 2001 – January 2009)	Lawyer – US qualified	Morrison & Foerster LLP, Standard Chartered Bank plc
David Shearer	NED (March 2004 – April 2007)	Accountant – CA, MBA	Deloitte LLP
Lord Stevenson	NED (September 2001 –December 2008) Chairman (September 2001 – January 2009)		Various media and finance companies including, BSKYB plc, Pearson plc, Thames Television, Tyne Tees TV, J Rothschild Assurance plc, Lazard Ltd

Appendix 7: Timeline of membership of HBOS Board



2005	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
Number of Executives	6	6	6	5	5	5	5	5	5	5	5	5
Number of Non-executives	9	9	9	9	8	8	8	8	8	8	8	8
Total Board members	15	15	15	14	13	13	13	13	13	13	13	13

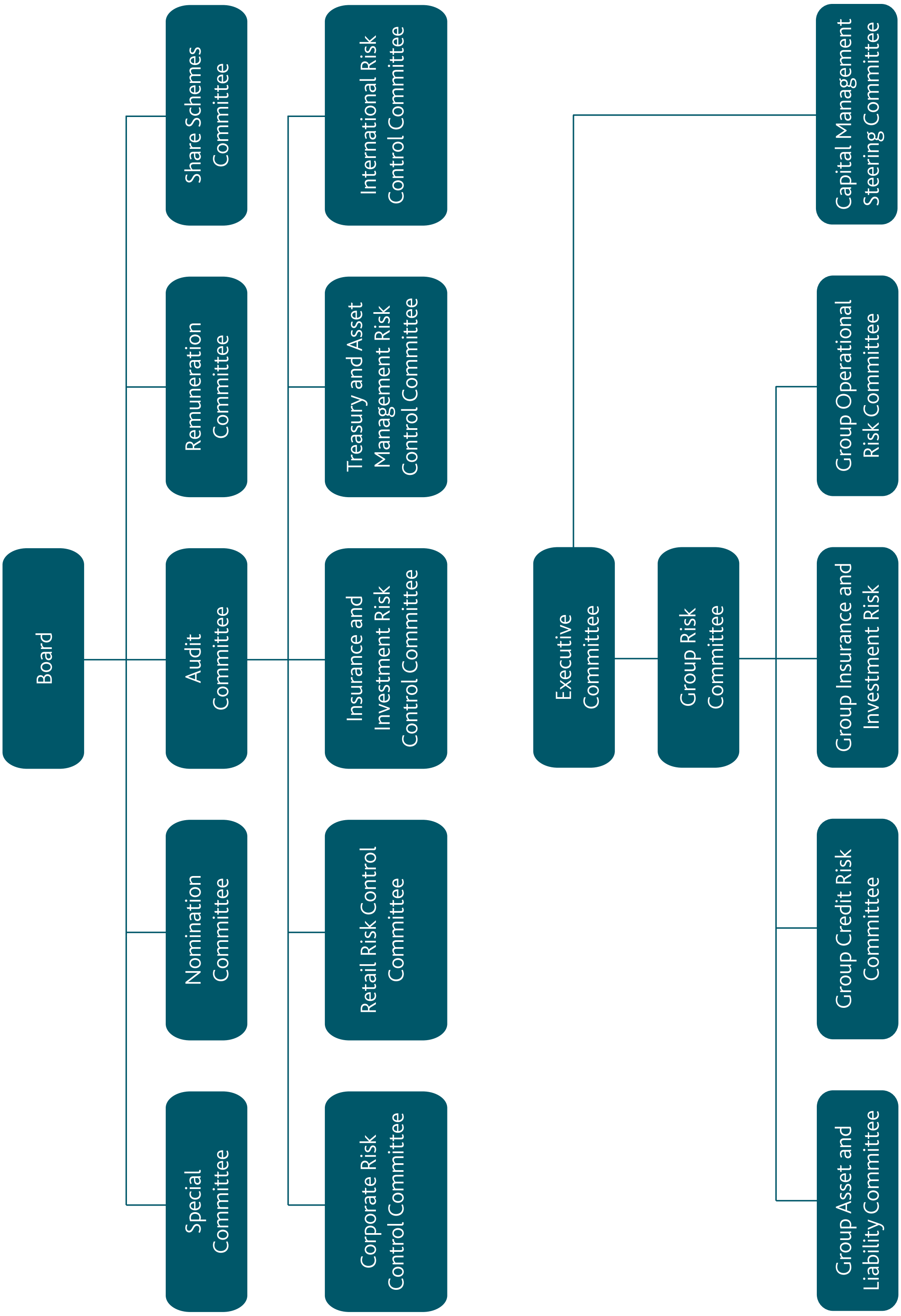
2006	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
Number of Executives	5	5	5	5	7	7	6	6	6	6	6	6
Number of Non-executives	9	9	9	9	9	9	9	9	9	9	9	9
Total Board members	14	14	14	14	16	16	15	15	15	15	15	15

2007	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
Number of Executives	6	6	6	6	6	6	6	6	8	8	8	8
Number of Non-executives	9	9	10	10	9	9	9	9	9	9	9	9
Total Board members	15	15	16	16	15	15	15	15	17	17	17	17

2008	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct
Number of Executives	7	7	7	7	7	7	7	7	7	7
Number of Non-executives	9	9	9	9	8	8	8	8	8	8
Total Board members	16	16	16	16	15	15	15	15	15	15

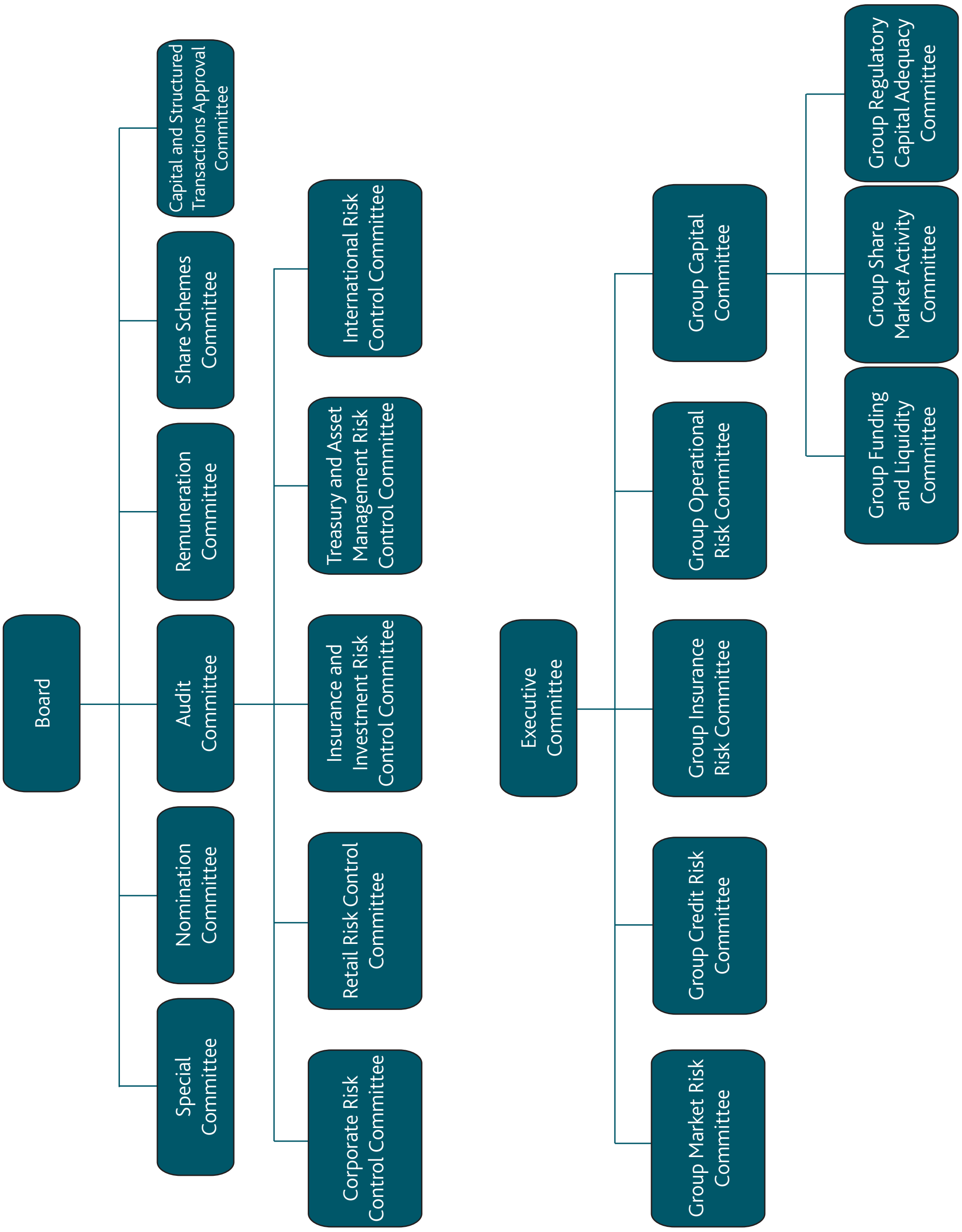
Appendix 8: HBOS plc structure of Board committees

Pre-2006



Reproduced by PRA.

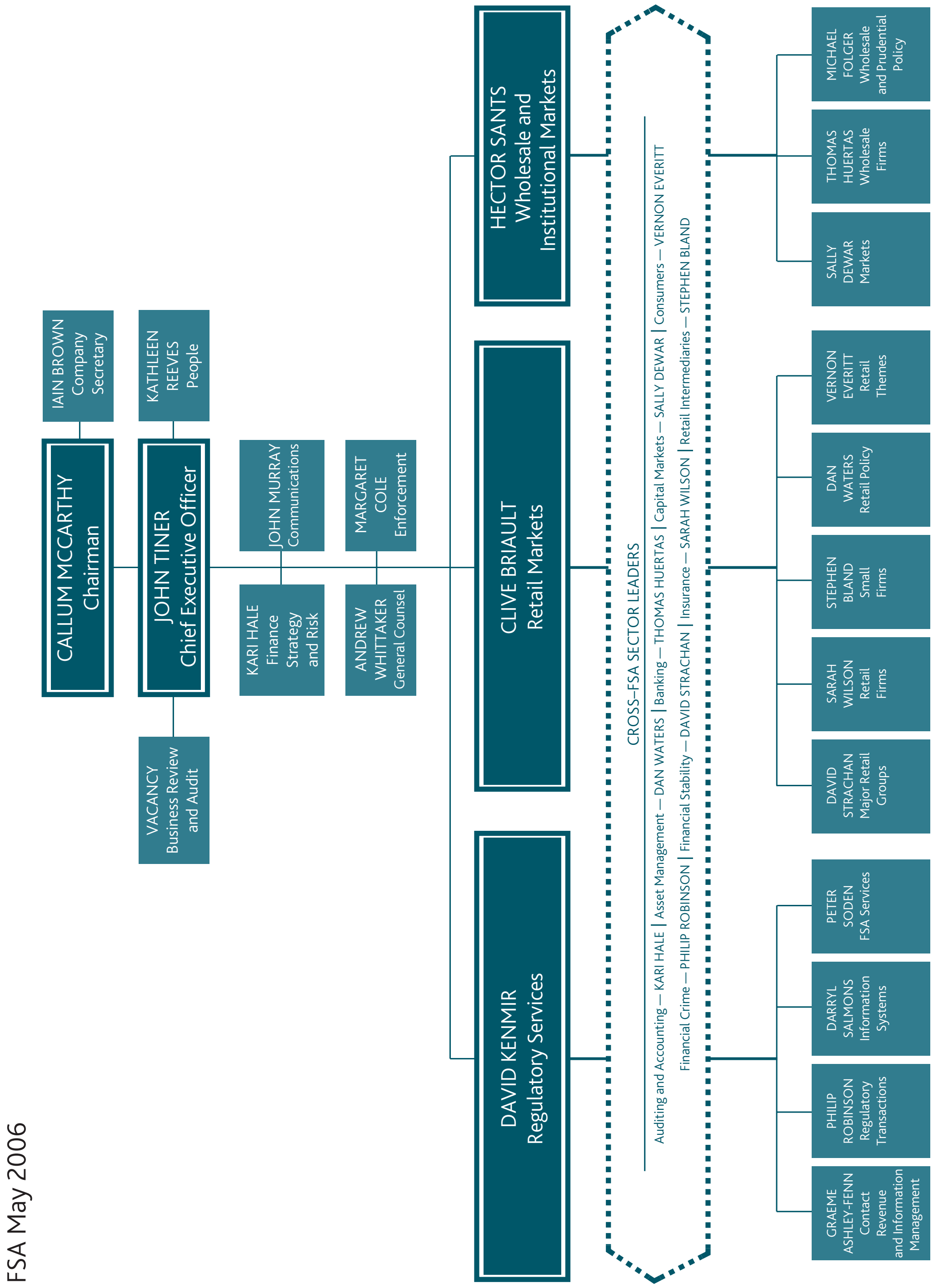
Post-2006



Reproduced by PRA.

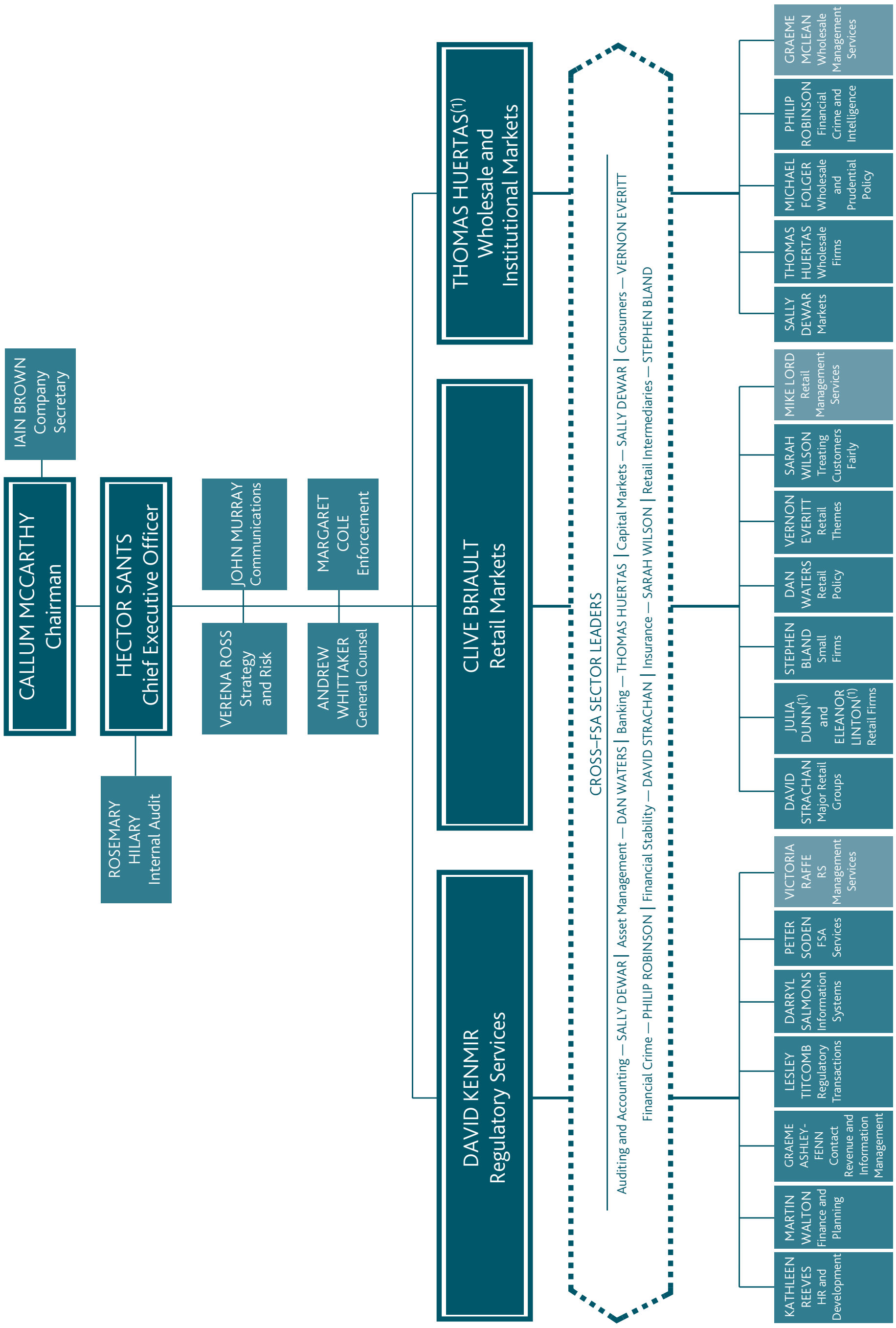
Appendix 9: The FSA's management and Board during the Review Period

FSA organogram as at May 2006



FSA organogram as at July 2007

FSA July 2007



(1) Acting.

Table of FSA Board members during the Review Period of 1 January 2005 – 1 October 2008

FSA Board members	Title	Period on FSA Board
Sir Callum McCarthy	Chairman	Start of Review Period – 19 September 2008
Lord Turner	Chairman	20 September 2008 – End of Review Period
Non-Executive Directors		
Dame Deirdre Hutton CBE	Deputy Chairman	Start of Review Period – 10 December 2007
Kyra Hazou		Start of Review Period – 18 January 2007
Tom de Swaan		Start of Review Period – 18 January 2007
Clive Wilkinson		Start of Review Period – 18 January 2007
Sir Andrew Large		Start of Review Period – 15 January 2006
Steve Thieke		Start of Review Period – 30 June 2005
James Crosby		Throughout Review Period
	Deputy Chairman from	11 December 2007 – End of Review Period
Karin Forseke		Throughout Review Period
Prof David Miles		Throughout Review Period
Michael Slack		Throughout Review Period
Hugh Stevenson		Throughout Review Period
Sir John Gieve		16 January 2006 – End of Review Period
Carolyn Fairbairn		11 December 2007 – End of Review Period
Peter Fisher		19 January 2007 – End of Review Period
Brian Flanagan		19 January 2007 – End of Review Period
Executive Directors		
John Tiner	CEO	Start of Review Period – 19 July 2007
Sir Hector Sants	CEO	20 July 2007 – End of Review Period
	Managing Director of Wholesale and Institutional Markets	Start of Review Period until becoming CEO
Sally Dewar	Managing Director of Wholesale and Institutional Markets	9 January 2008 – End of Review Period
Clive Briault	Managing Director of Retail Markets	Start of Review Period – 30 April 2008
Jon Pain	Managing Director of Retail Markets	8 September 2008 – End of Review Period
David Kenmir	Managing Director of Regulatory Services	Throughout Review Period

Table of FSA ExCo members during the Review Period of 1 January 2005 – 1 October 2008

ExCo members	Title	Period on ExCo
John Tiner	CEO	Start of Review Period – 19 July 2007
Sir Hector Sants	Managing Director of Wholesale and Institutional Markets	Start of Review Period until becoming CEO
	CEO	20 July 2007 – End of Review Period
Thomas Huertas[(a)]	Managing Director of Wholesale and Institutional Markets	20 July 2007 – 7 January 2008
Sally Dewar	Managing Director of Wholesale and Institutional Markets	9 January 2008 – End of Review Period
Clive Briault	Managing Director of Retail Markets	Start of Review Period – 30 April 2008
Jon Pain	Managing Director of Retail Markets	8 September 2008 – End of Review Period
David Kenmir[(b)]	Managing Director of Regulatory Services Managing Director of Retail Markets	Throughout Review Period
Andrew Whittaker	General Counsel	Throughout Review Period
Andrew Procter	Director of Enforcement	Start of Review Period – 7 January 2005
Margaret Cole	Director of Enforcement	18 July 2005 – End of Review Period
Vernon Everitt	HR Director – People and Communications Division	1 October 2003 – 2 October 2005
	Director – Retail Themes Division	3 October 2005 – 30 September 2007
Kathleen Reeves[(c)]	Director of Human Resources Chief Operating Officer	18 October 2005 – End of Review Period
Kari Hale	Director of Finance Strategy & Risk Division	1 June 2004- 31 May 2007
Verena Ross	Director of Finance Strategy & Risk Division	29 November 2006 – End of Review Period

(a) Thomas Huertas was acting Managing Director of Wholesale and Institutional Markets from 20 July 2007 – 7 January 2008
(b) David Kenmir was acting Managing Director of Retail Markets from 1 May 2008 – 7 September 2008
(c) Kathleen Reeves was acting Chief Operating Officer from 1 May 2008 – 7 September 2008

Appendix 10: Glossary of main terms, other acronyms and abbreviations

Glossary of main terms

Advanced Measurement Approach (AMA)

A set of operational risk measurement techniques proposed under Basel II capital adequacy rules for banks, building societies and investment firms. Under this approach, firms are allowed to develop their own empirical models to quantify required capital for operational risk. The use of this approach by firms is subject to approval from their home regulators.

Advanced Rating Based Approach (AIRB)

A set of credit risk measurement techniques proposed under Basel II capital adequacy rules for banks, building societies and investment firms. Under this approach, firms are allowed to develop their own empirical models to quantify required capital for credit risk. The use of this approach by firms is subject to approval from their home regulators.

Alternative A-paper Mortgage (Alt-A)

A classification of mortgages where the risk profile falls between prime and subprime.

Approved Person

A person who had been approved by the FSA to perform a controlled function (relating to the carrying on of a regulated activity by a firm).

ARROW letter

The FSA communicated the results of its risk assessment to the firm in an ARROW letter. This set out the FSA's view of the risks that the firm posed and was accompanied by the RMP that detailed the issues identified and the actions to be taken by the firm (and the FSA) to address those issues.

ARROW risk assessment

A risk assessment of the probability of the business and control risks (as defined within the ARROW risk model) crystallising within a firm. The supervision team had discretion to investigate any areas and issues during the assessment to the extent they saw fit, subject to challenge by those validating the risk assessment (see ARROW panel).

ARROW II was rolled out from March 2006 and all associated changes were implemented by June 2007. The changes made from ARROW I were designed: more closely to align the firm, thematic and internal frameworks with ARROW; to implement better controls over the supervisory process; to help ensure the application of a consistent approach; and to make better use of thematic work and sector intelligence. ARROW II also aimed to improve communication to firms.

ARROW panel

A committee of the FSA's staff convened to validate a firm's risk assessment, either at the planning or validation stage. For high impact firms, the panel would be chaired by the relevant

FSA Director, or a Head of Department and contain independent members from other supervision and specialist departments (see planning and validation panels).

ARROW planning panel

The process by which the scope of an ARROW risk assessment and discovery plan was challenged and approved. Planning validation took place after the discovery plan was produced and before the risk assessment visit to the firm began. The aim of planning validation was to ensure that the structure of the risk assessment and the scope of the discovery plan were appropriate before starting the visit. It provided an opportunity for supervisors to receive senior and expert input to their assessment at an early stage.

ARROW validation panel

Final validation panels occurred after discovery (i.e. the visits to the firm) and evaluation and before sending the ARROW letter to the firm. Their aim was to ensure that the ARROW risk framework was applied consistently, to provide challenge, and to approve the conclusions of the discovery work, the ARROW letter and the appendices (including the Risk Mitigation Programme). All high impact firm risk assessments were subject to final validation. The members of the validation panel were, as far as possible, consistent with those of the Planning Panel.

Asset Backed Commercial Paper conduit (ABCP conduit)

Asset backed commercial paper (ABCP) conduits issue short-term commercial paper (CP) backed by a pool of assets. In order to ensure it can pay the CP as it falls due, the conduit has liquidity facilities provided by a bank or banks, as well as credit enhancement. Where the bank originates the loans/assets purchased by the conduit, the conduit is referred to as an 'own-asset' conduit; otherwise the assets are purchased from a third party. A 'securities arbitrage' conduit seeks to benefit from the difference between short-term funding costs and long-term asset returns. Where the assets are purchased by the conduit from one originator, the conduit is referred to as a 'single seller' conduit; 'multi-seller' conduits have pools of assets purchased from multiple originators.

Asset-Backed Security (ABS)

A security whose value and income payments are derived from and collateralised (or 'backed') by a specified pool of underlying assets.

Available For Sale (AFS)

An accounting term used to classify financial assets. AFS is one of the three general classifications, along with 'held for trading' and 'held to maturity'.

Banking Book

In order to calculate regulatory requirements, institutions classify their assets and off balance sheet items into those in their banking books and those in their trading books. The banking book is the assumed approach for all positions, with entry criteria determining positions that should be included in the trading book (for a definition of Trading Book, please see below). The majority of assets held by UK banks and building societies are held in the banking book.

Basel requirements

The Basel Committee on Banking Supervision is the international body which provides a forum for regular cooperation on banking supervision matters, and develops international guidelines and supervisory standards. It has developed three principal sets of international banking regulations:

Basel I: The original Basel Accord was agreed in 1988 by the Basel Committee on Banking Supervision. The 1988 Accord, now referred to as Basel I, helped to strengthen the soundness and stability of the international banking system as a result of the higher capital ratios that it required.

Basel II: The Basel II framework, initially published in June 2004, introduced the concept of three 'pillars'. Pillar I sets out the minimum capital requirements firms will be required to meet for credit, market and operational risk. Under Pillar 2, firms and supervisors have to take a view on whether a firm should hold additional capital against risks not covered in Pillar I and must take action accordingly. Pillar 3 aims to improve market discipline by requiring firms to publish certain details of their risks, capital and risk management

Basel III: The crisis in financial markets in 2008 and 2009 prompted a strengthening of the Basel rules to address the deficiencies exposed in the previous set of rules. The Basel III proposals seek to strengthen the regulatory regime applying to credit institutions in the following areas: enhancing the quality and quantity of capital; strengthening capital requirements for counterparty credit risk (and for market risk in CRD III) resulting in higher Pillar I requirements for both; introducing a leverage ratio as a backstop to risk-based capital; introducing two new capital buffers: one on capital conservation and one as a countercyclical capital buffer; and implementing an enhanced liquidity regime through the Net Stable Funding Ratio and Liquidity Coverage Ratio.

Blue Book

Management accounts as presented to HBOS ExCo on a monthly basis.

Board Effectiveness Review

A review of the effectiveness of a company's board of directors, undertaken either by the company itself (with or without the assistance of an external facilitator), or by an external party.

Capital

A bank's capital comprises equity and debt instruments that absorb losses ahead of claims by depositors and other creditors. Regulators require banks to hold minimum amounts of capital relative to their (risk-weighted) assets to cover unexpected losses.

Capital assessment

The framework for assessing the capital adequacy for regulated entities. For banks and investment firms, this was the Supervisory Review & Evaluation Process (SREP) under Basel II (implemented in the European Union via the Capital Requirements Directive (CRD)). The capital assessment undertaken was part of the overall risk assessment under ARROW and conclusions and issues arising from the capital assessment were taken into consideration in the wider ARROW assessment (and vice versa). Where feasible, capital assessments were undertaken concurrently with the wider ARROW assessment.

Capital Requirements Directive (CRD)

The Basel I and II Accords are implemented in the European Union via the CRD. This includes the standardised and advanced measurement approaches for the calculation of the capital requirement relating to both operational and credit risk.

Churn

The rate of redemption or refinancing of loans.

Close and Continuous (C&C)
Close and Continuous supervision refers to the additional scheduled programme of meetings outside of the periodic ARROW assessments.

Collateral
The assets pledged as security against money owed.

Commercial Paper (CP)
An unsecured, short-term debt instrument issued by an entity, typically for the financing of accounts receivable, inventories and meeting short-term liabilities.

Compound Annual Growth Rate (CAGR)
The year-on-year growth rate of an investment over a specified period of time.

Controlled Function
'Controlled functions' are the roles or responsibilities that the regulator has identified as being key to the operation of a regulated firm. A regulated firm must ensure that no person performs a controlled function in relation to any regulated activity unless the regulator has first approved that person to perform that function.

Core Tier 1 Capital
Shareholders equity and retained earnings are commonly referred to as "Core" Tier 1 capital, whereas Tier 1 is core Tier 1 together with other qualifying Tier 1 capital securities.

Credit Default Swap (CDS)
A derivative contract that transfers credit risk in return for a series of payments.

Credit Guarantee Scheme (CGS)
The CGS forms part of the UK Government's measures to assure the stability of the financial system and to protect ordinary savers, depositors, businesses and borrowers. The scheme became operational on 13 October 2008 and closed to new issuance on 28 February 2010.

'Crisis Period'
In this Report, the period starting on 9 August 2007, in which conditions in the financial markets deteriorated significantly. As a consequence, from 9 August 2007 the FSA took part in daily discussions of the latest market conditions with the other Tripartite Authorities.

Current Status Indicator (CSI)
The FSA collected CSI liquidity data twice-weekly from HBOS and other major banks and building societies from September 2007 to August 2008, to supplement the liquidity data collected under the Sterling Stock Regime. These data were used as an interim monitoring tool for liquidity risk. The CSI report was not a formally required regulatory return, nor was it used to set regulatory limits. Firms completed the CSI reports on a 'best efforts' basis.

Decision Making Committee (DMC)
DMCs took the decision whether the FSA should approve a firm's Basel II IRB or AMA application. The committee acted under delegated authority, and drew its membership from the supervision departments, the specialist Risk Review Department and the then Permissions, Decisions and Reporting division. The chair was required to be a Head of Department or more senior person, and independent of the firm's supervision team. The FSA's policy and legal departments were also required to attend in an advisory capacity.

De Montfort Review
A report analysing the lending activity of the major commercial property lenders operating in the UK prepared by the De Montfort University Leicester.

Due Diligence
The examination of a potential target for merger, acquisition, or similar corporate finance transactions normally by a possible buyer.

Emergency Liquidity Assistance (ELA)
In exceptional circumstances, as part of its central banking functions, the Bank of England acts as 'lender of last resort' to financial institutions in difficulty in order to prevent a loss of confidence spreading through the financial system.

Fair value
The amount at which an asset can be bought or sold in a transaction between willing parties.

Financial Policy Committee (FPC)
The Financial Services Act 2012 established a Financial Policy Committee (FPC). The Committee is charged with identifying, monitoring and taking action to remove or reduce systemic risks to the stability of the financial system and has a secondary objective to support the economic policy of the Government.

Grampian
One of HBOS's asset-backed commercial paper (ABCP) conduits, the largest in Europe at the time (see entry on ABCP Conduits for further explanation).

Goodwill
Goodwill is an intangible asset that usually arises when a company buys another business. When a company purchases a business, it usually pays for the actual costs of all assets and liabilities listed on the selling company's balance sheet. Any amount given to the selling company above the value of balance sheet items represents goodwill.

High-impact firm
A category of firm where crystallised risk would have the greatest impact on the FSA's statutory objectives. The population of high-impact firms was agreed by the FSA's Executive Committee. Only 'high-impact firms' were subject to close and continuous supervision.

Impairment loss or charge
The estimated loss on an impaired asset that is charged to the income statement. Please refer to Appendix 4, Question 1 of the Questions from the Parliamentary Commission on Banking Standards.

Impairment provision
The difference between the balance sheet value of an impaired asset and its estimated recoverable amount.

Individual Capital Guidance (ICG)
Guidance given by the FSA on the amount and quality of capital resources which the FSA considers a firm needs to hold. Firms are expected to maintain financial resources at or above the level specified in the ICG at all times.

Individual Capital Ratio (ICR)
Guidance given by the FSA on the amount and quality of capital resources which the FSA considers a firm needs to hold. Following the introduction of Basel II FSA guidance was renamed ICG.

Integrated lending
Lending at all levels in the funding structure (i.e. debt, mezzanine and equity).

Interim ARROW assessment
Between full ARROW risk assessments the FSA could elect to conduct an Interim Assessment or 'stock take' to update the firm on its view of the firm's risks, as well as its progress in complying with its RMP. In practice, for a high impact firm with a 24 month Regulatory Period, this would usually take place after twelve months.

Interim Risk Manager (IRM)
IRM was the system that the FSA introduced in mid-2006 for the administration of ARROW assessments. It was used to record details of risks and probability assessments as well as the production of documentation such as RMPs.

Investment Property Databank (IPD) UK Index
The IPD Annual Index covers approximately 12,000 directly held UK property investments.

Junior Debt
Junior debt is debt that is either unsecured or has a lower priority than of another debt claim on the same asset or property. It is a debt that is lower in repayment priority than other debts in the event of the issuer's default. Junior debt is usually an unsecured form of debt, meaning there is no collateral behind the debt.

Landale
An HBOS asset-backed commercial paper conduit.

Legal Cutover
The date of establishment of the PRA and FCA. The FSA ceased to exist on this date.

Leverage
The amount of debt used to finance a firm's assets. A firm with significantly more debt than equity is considered to be highly leveraged.

Leveraged finance
Funding a company or business unit with more debt than would be considered normal for that company or industry implying that the funding is of greater risk, and therefore more costly, than normal borrowing. As such, leveraged finance is commonly used to achieve a specific, often temporary, transaction for example to make an acquisition, effect a buy-out, repurchase shares or fund a one-time dividend.

Liquidity
Liquidity refers to a business's ability to repay its debts and obligations as they fall due through its ability to convert its assets to cash easily and at a minimum loss of value.

Liquidity Coverage Ratio (LCR)
One of the two Basel III minimum liquidity standards (the other being the Net Stable Funding Ratio), published in December 2010. The objective of this standard is to promote short-term

resilience of a bank's liquidity risk profile by assuring that it has sufficient high-quality liquid assets to survive a significant stress scenario lasting for one month.

Loan to Value (LTV)
The ratio of a loan to the value of the property it is secured against.

London Interbank Offered Rate (LIBOR)
The average interest rate that banks offer to provide unsecured lending to each other at.

Major Retail Group Division (MRGD)
The relevant FSA division responsible for the supervision of HBOS.

Marks
The value at which a firm has priced its positions.

Mark-to-Market (MTM)
Accounting terminology referring to assigning a value to financial instrument position based on the current fair value of the instrument or similar instruments.

Mezzanine Capital
A subordinated debt or preferred equity instrument that represents a claim on a company's assets which is senior only to that of the common shares. Mezzanine financings can be structured either as debt (typically an unsecured and subordinated note) or preferred stock.

Minority Interest
A significant but non-controlling ownership (of less than 50%) of a company's shares by either an investor or another company.

Mortgage-Backed Security
An asset-backed security where the pooled loans that secure underlying cash flows of the bond are made up of mortgages.

Overnight Indexed Swap (OIS)
An interest rate swap where a fixed interest rate is exchanged for a floating interest rate, calculated by reference to an overnight indexed rate.

Northern Rock Report
Financial Services Authority report entitled *The supervision of Northern Rock: a lessons learned review*, March 2008.

Originate-to-distribute model
When lenders make loans with the intention of selling them to other institutions and/or investors, as opposed to holding the loans through maturity.

Plenderleith Report
Review of the Bank of England's provision of Emergency Liquidity Assistance in 2008–09. Report prepared by Ian Plenderleith, October 2012.

Preference Share
Share on which shareholders are paid out in preference to, i.e. before, ordinary shares. In the event of a company bankruptcy, preferred shareholders have a right to be paid company assets

first. Preference shares typically pay a fixed dividend, whereas ordinary shares do not. Unlike common shareholders, preference share shareholders usually do not have voting rights.

Probability of Default (PD)

Parameter used in credit risk models to calculate the regulatory capital requirement under Basel II. It is a measure of the likelihood that a loan will not be repaid and as a result the default of the party to which the loan was made.

Pro-cyclicality

Pro-cyclicality refers to the potential for IRB models to be correlated with the performance of the economy. As the economy deteriorates the IRB models require firms to hold more capital, potentially reducing their willingness to lend, with further implications for the economy.

Property investment lending

A category of commercial property lending: the loan funds the purchase of a property by a borrower for investment purposes. The borrower leases the asset to an end user, which may be for commercial (e.g. factories or offices) or retail (e.g. flats) use in exchange for rental income. The principal on the loan may be amortising, being paid back from the rental streams on the underlying asset and/or from refinancing the loan at maturity. The property asset provides security for the loan.

Property development lending

A category of commercial property lending: the loan funds the construction or further development/refurbishment of a property. Recovery of the loan is typically a single repayment at the end of the project achieved by the sale of the completed property, or refinancing as the property is reclassified property investment. Risks include the time to completion and that demand and/or prices might fall in the meantime affecting final recovery, cost over-runs require further funding commitments and the greater potential for adverse changes in the bank's own funding costs. Pre-let or pre-sold developments can reduce some of the risk. In the years prior to 2007 speculative developments increased as a percentage of development finance.

Prudential Regulation Authority (PRA)

The PRA is part of the Bank of England and on 1 April 2013 took over responsibility for the prudential regulation of banks, building societies, credit unions, investment firms and insurance companies from the FSA.

RBS Report

Financial Services Authority Board Report entitled *The Failure of the Royal Bank of Scotland*, December 2011.

Regulatory Dividend

The concept of a 'regulatory dividend' was introduced in 2006 and was intended as an incentive for firms: in recognition of the firm 'doing the right thing', regulation would be less intensive.

Regulatory News Service (RNS)

RNS is a regulatory and financial communications channel for companies to communicate with the professional investor.

Regulatory period

The period of time between two consecutive ARROW risk assessments. The Regulatory period varied in length from one to four years, although this was restricted to a maximum of two years for 'high impact firms'.(314) The length depended on the risk profile of the firm and the time for which supervision believed the ARROW risk assessment would remain valid. A long Regulatory Period would denote a view of a firm presenting less risk (based on an assessment of the impact and the likelihood of risks crystallising).

Repo
A repurchase agreement or 'repo' is the sale of a security with an agreement to repurchase it at a fixed price on a specific future date.

Residential Mortgage-Backed Security (RMBS)
A type of mortgage-backed security backed by mortgages on residential real estate.

Reverse repo
A reverse repo is the purchase of a security with an agreement to resell it at a fixed price and on a specific future date.

Reverse Stress Test
A stress test that identifies events or economic scenarios that would cause a firm to fail.

'Review Period'
For this Report, the period between 1 January 2005 to 1 October 2008.

Rights Issue
A rights issue is a way in which a company can sell new shares in order to raise capital. Shares are offered to existing shareholders in proportion to their original holding. The price at which the shares are offered is usually at a discount to the current share price.

Risk Mitigation Programme (RMP)
The ARROW risk assessment usually led to a programme of further actions to address specific risks during the Regulatory Period.

The RMP would set out:

- the detail of each issue;
- the intended outcome that supervision sought for each issue;
- the action to be taken to achieve the intended outcome, specifying whether the action was to be taken by the FSA or the firm; and
- the timetable for the action.

Risk Weighted Assets (RWA)
A measure of the risk of an asset determined following one of the approaches, initially set out by the Basel Committee of Banking Supervisors within the Basel Accord or Basel II, but as implemented in the UK in the FSA's handbook.

Sarbanes-Oxley
The Sarbanes Oxley Act of 2002. This US legislation set new or enhanced existing standards for all US public company boards, management and public accounting firms.

(314) Following the Northern Rock Report, the Supervisory Enhancement Programme set the Regulatory Period for HIFs to a maximum of two years.

Section 166 Report
A report commissioned by the FSA but undertaken by a third party to address a particular regulatory need identified by the FSA relating to a regulated financial services business under Section 166 of the Financial Services and Markets Act 2000.

Securitisation
A financial transaction in which assets are pooled and securities representing interests in the pool are issued.

Secured funding
Liabilities and general obligations that are collateralised by legal rights to specifically designated assets owned by the borrowing institution in the case of bankruptcy, insolvency, liquidation or resolution.

Senior debt
Debt that takes priority over other debt owed by the issuer. In event of bankruptcy of the issuer, senior debt must be repaid first from proceeds of liquidation.

Shadow Banking System
The collection of financial intermediaries that provide services similar to traditional commercial banks, but whose members are not subject to regulatory oversight.

Short selling
A trading strategy aimed at taking advantage of an expected fall in prices. An investor, normally via a broker, sells shares that are not actually owned but have been borrowed from another investor or broker. The shares have to be bought back so they can be returned to the lender.

Significant Influence Function (SIF)
The most senior controlled functions within FSA authorised firms. For example, the Chairman, Executive and Non-Executive Directors, the CEO and the Head of Compliance.

Slotting
A methodology for calculating credit risk capital requirements for specialised lending (including forms of commercial real estate lending). Banks map their exposures to one of five categories (strong, good, satisfactory, weak or default), each of which is associated with risk weights for unexpected and expected losses.

Special Liquidity Scheme (SLS)
A scheme introduced by the Bank of England in April 2008 to improve the liquidity position of the banking system by allowing banks and building societies to swap their high quality mortgage-backed and other securities for UK Treasury Bills for up to three years. The Scheme was designed to finance part of the overhang of illiquid assets on banks' balance sheets by exchanging them temporarily for more easily tradable assets. The drawdown period for the SLS closed on 30 January 2009.

Sterling Stock Liquidity Regime (SSLR)
During the Review Period, the prevailing FSA quantitative regulatory liquidity standard for large retail banks (referred to as sterling stock banks). It was originally implemented in 1996 and applied on a consolidated basis. The basic requirement of the SSLR sought to ensure that, for its sterling business, a bank had enough unencumbered highly liquid eligible sterling assets to cover wholesale net outflows and a 5% retail outflow for the first week (five business days) of a

liquidity crisis, without recourse to the market for renewed wholesale funding. The liquidity of the sterling stock banks was measured by the Sterling Stock Liquidity Ratio.

Stress Testing

A technique used to assess the potential loss of a portfolio of assets through market, credit or operational risk e.g. historical stress tests and scenario analysis. Macroeconomic stress testing is conducted based on changes in macroeconomic variables, such as changes in inflation or unemployment, and the effect that such changes would have on a firm.

Structured credit

Products comprising tranches of portfolios of credit instruments or exposures. Structured credit products include cash Collateralised Debt Obligations and synthetic Collateralised Debt Obligations.

Sub-prime mortgage

Loan to a sub-prime borrower, typically having a weaker credit history that includes payment delinquency, court judgement and bankruptcy. These loans generally carry higher interest rates and pre-payment penalties.

Supervision team

The group of staff, led by a relationship manager, responsible for the direct supervision of a particular firm/group. The supervision team acted as the main contact point between the FSA and the firm and the focal point for coordinating the use of specialists from other areas of the FSA in order to achieve supervisory outcomes.

Supervisory Enhancement Programme (SEP)

A programme of radical reform of the FSA's approach to the supervision of high impact firms, launched in April 2008, which incorporated the findings of the FSA's Internal Audit Report into the failure of Northern Rock. It was further intensified in response to the findings of *The Turner Review* in March 2009 and following international regulatory reviews of appropriate supervisory standards.

Supervisory Review and Evaluation Process (SREP)

The regulator's assessment of the adequacy of certain firms' capital.

Threshold Conditions

The threshold conditions are set out in Schedule 6 of the Financial Services and Markets Act 2000. The threshold conditions represent the minimum conditions which a firm is required to satisfy, and continue to satisfy, in relation to all the regulated activities for which it has applied for permission. The regulator is obliged to ensure that applicants for permission satisfy the threshold conditions on a continuing basis.

Tier 1/Tier 2 Capital

Classification of different types of regulatory capital. Tier 1 capital comprises common equity, retained earnings and some types of debt instruments that convert into equity or can be written down. Tier 2 capital comprises other types of debt instruments that convert into equity or can be written down.

Trading Book

A trading book consists of positions in financial instruments and commodities held either with trading intent or in order to hedge other elements of the trading book. To be eligible for trading book capital treatment, financial instruments must either be free of any restrictive covenants on their tradability or be able to be hedged completely. In addition, positions should be frequently and accurately valued, and the portfolio should be actively managed.

Tripartite Authorities
The three UK authorities who shared responsibility for the UK's financial stability during the Review Period: HM Treasury, The Bank of England and the FSA.

Turner Review
The Turner Review – A regulatory response to the global banking crisis was a report by FSA chairman Lord Turner that made recommendations for reforming UK and international approaches to the way banks are regulated. Published in March 2009.

Unencumbered Asset
An asset which is not pledged (either explicitly or implicitly) to secure, collateralise or credit-enhance any transaction.

Underlying profit before tax (UPBT)
A firm's measure of its profits rather than a measure prescribed by accounting or other regulatory standards. It normally reflects the firm's view of ongoing profits from its business, excluding exceptional or one-off items not usually incurred in the normal course of business.

Walker Review
A review by Sir David Walker of corporate governance in UK banks and other financial industry entities. Published in November 2009.

Write-off
An accounting treatment that nullifies the book value of an over-valued asset.

Wrong way risk
The risk that occurs when exposure to a counterparty and the credit quality of that counterparty are adversely correlated.

Other acronyms and abbreviations

3LoD
Three Lines of Defence

ABS
Asset Backed Securities

ADI
Authorised Deposit Institution

ALM
Asset and Liability Management

APRA
Australian Prudential Regulation Authority

BIPRU
Prudential sourcebook for Banks, Building Societies and Investment Firms

BoE
Bank of England

BTL
Buy to let

C&C
Close and Continuous

CEO
Chief Executive Officer

CFO
Chief Financial Officer

CPG
Contingency Planning Group

CRDIV
Capital Requirements Directive IV

CRE
Commercial Real Estate

CSI
Current Status Indicator

DMC
Decision Making Committee

EEA
European Economic Area

ENA
Europe and North America

ESB
Electricity Supply Board (Ireland)

ExCo
Executive Committee

'Fannie Mae'
Federal National Mortgage Association

FCA
Financial Conduct Authority

FMC
Firms and Markets Committee

FRC
Financial Reporting Council

'Freddie Mac'
Federal Home Loan Mortgage Corporation

FRO
Financial Risk Outlook

FSA
Financial Services Authority

FSMA
Financial Services and Markets Act 2000

FSR
Financial Stability Report

GAAP
Generally Accepted Accounting Principles

GFD
Group Finance Director

GFR
Group Financial Risk

GIA
Group Internal Audit

GR
Group Risk

GRD
Group Risk Director

GRR
Group Regulatory Risk

HoD
Head of Department

IAS
International Accounting Standards

ICAAP
Internal Capital Adequacy Assessment Process

ICR
Individual Capital Ratio

IFRS
International Financial Reporting Standards

IFSRA
Irish Financial Services Regulatory Authority

IMF
International Monetary Fund

IRB
Internal Ratings Based

IRCC
International Risk Control Committee

ISAF
Integrated Structured and Acquisition Finance

KPMG
KPMG LLP

LIBOR
London inter-bank offered rate

LRP
Liquidity Risk Profile report

LTV
Loan to Value

MD
Managing Director

MGC&C
Management, Governance, Culture and Controls

MI
Management Information

MRGD
Major Retail Groups Division

NAO
National Audit Office

NED
Non-Executive Director

NSFR
Net Stable Funding Ratio

ONS
Office for National Statistics

P&L
Profit and Loss

PCBS
Parliamentary Commission on Banking Standards

PPI
Payment Protection Insurance

PRA
Prudential Regulation Authority

QIS
Quantitative Impact Study

RCC
Risk Control Committee

RE
Real Estate

RMBS
Residential Mortgage Backed Security

RPC
Regulatory Policy Committee

RSD
Risk Specialists Division

SME
Small or medium sized enterprise

SSR
Sterling Stock Regime

SYSC
Senior Management Arrangements, Systems and Controls

TCF
Treating Customers Fairly

TSC
Treasury Select Committee