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House of Lords
House of Commons

Parliamentary Commission on
Banking Standards

'An accident waiting to happen': The failure of HBOS

Fourth Report of Session 2012-13

Volume I: Report, together with formal minutes

Volume II (oral and written evidence) is available on the Commission's website, www.parliament.uk/bankingstandards

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Parliamentary Commission on Banking Standards

The Parliamentary Commission on Banking Standards is appointed by both Houses of Parliament to consider and report on professional standards and culture of the UK banking sector, taking account of regulatory and competition investigations into the LIBOR rate-setting process, lessons to be learned about corporate governance, transparency and conflicts of interest, and their implications for regulation and for Government policy and to make recommendations for legislative and other action.

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The Lord Archbishop of Canterbury (Non-Affiliated)
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Baroness Kramer (Liberal Democrat)
Rt Hon Lord Lawson of Blaby (Conservative)
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Rt Hon Lord McFall of Alcluith (Labour/Co-operative)
John Thurso MP (Liberal Democrat, Caithness, Sutherland and Easter Ross)
Lord Turnbull KCB CVO (Crossbench)

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The Reports and evidence of the Commission are published by The Stationery Office by Order of the House. All publications of the Commission (including press notices) are on the Internet at <http://www.parliament.uk/bankingstandards>.

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The following parliamentary staff are currently working for the Commission:

Colin Lee (Commons Clerk and Chief of Staff), Adam Mellows-Facer (Deputy Chief of Staff), Richard McLean (Lords Clerk), Lydia Menzies (Second Clerk), Lucy Petrie (Second Clerk), Robert Law (Commission Specialist), Jay Sheth (Commission Specialist), Gavin Thompson (Commission Specialist), James Abbott (Media Officer), James Bowman (Senior Committee Assistant), Claire Cozens (Senior Committee Assistant), Baris Tufekci (Committee Assistant), Ann Williams (PA to the Chief of Staff) and Danielle Nash (Committee Support Assistant).

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Footnotes

In the footnotes of this Report, references indicated by 'BQ' and followed by a question number refer to oral evidence taken by sub-committee B: Panel on HBOS, published by the Commission in the second volume of this Report.

References indicated by 'Q' and followed by a question number refer to oral evidence taken by the Commission. Transcripts of this oral evidence and the second volume are available at

<http://www.parliament.uk/business/committees/committees-a-z/joint-select/professional-standards-in-the-banking-industry/publications/>.

References indicated by 'B Ev w' followed by a page number refer to written evidence published by the Commission in the second volume. This second volume and other written evidence taken by the Commission and its panels are available at the above address.

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1 Introduction

1. On 27 January 2004 the Board of HBOS plc was told by the Group Finance Director, Mike Ellis, that, in the view of the Financial Services Authority (FSA):

the Group's growth had outpaced the ability to control risks. The Group's strong growth, which was markedly different than the position of the peer group, may have given rise to **"an accident waiting to happen"**.¹

Neither the FSA nor HBOS followed through on the implications of this characterisation. The accident happened. HBOS failed, with dramatic consequences for its shareholders and for the taxpayer. In this Report we examine why HBOS failed and what that failure says about culture and standards in UK banking.

2. At its peak in 2007, HBOS had a market capitalisation of over £40 billion, when its tangible book value was £18 billion.² Former HBOS shareholders have seen 96 per cent of its peak value disappear, and what remains is the result of support from the UK taxpayer and the acquisition by Lloyds TSB. The taxpayer has injected £8.5 billion directly into HBOS. Lloyds Banking Group (LBG) has provided a further £20.5 billion for HBOS and has itself also received £12 billion from the taxpayer. The total of £20.5 billion provided by the taxpayer to both groups has therefore all been channelled into HBOS.³ The market value of the Treasury holding in LBG is still £5 billion below the £20.5 billion invested.⁴ There have also been wider effects of the catastrophe, with HBOS weakened in its ability to lend to retail customers and small- and medium-sized enterprises (SMEs) and the banking market less diverse.

3. Two of the three large domestic bank failures of the banking crisis in the UK have previously been the subject of detailed scrutiny. The retail bank run on Northern Rock and its consequences were subject to near contemporaneous consideration by the Treasury Committee.⁵ At the initiative and insistence of the Treasury Committee, the FSA—which had initially published only a 300 word press release to accompany the conclusion of its enforcement process—published a substantial Report into the failure of RBS, which was, also at the instigation of the Treasury Committee, subject to independent review by specialist advisers appointed by that Committee. Subsequently the Treasury Committee produced its own Report following that from the FSA.⁶ The fall of HBOS has so far received less public scrutiny, consideration being largely limited to sections in a Report by the Treasury Committee in 2009.⁷

1 B Ev w 363; emphasis in the original. For attribution of the last phrase, see Q 1328 and BQq 330-332.

2 HBOS, *2007 Annual Report and Accounts: Delivering our strategy...*, pp 154, 155, 207

3 National Audit Office, *HM Treasury Resource Accounts 2011-12: The Comptroller and Auditor General's Report to the House of Commons*, July 2012, p 10

4 Lloyds Banking Group, *2011 Annual Report and Accounts: Becoming the Best Bank for Customers*, pp 290, 303

5 Treasury Committee, Fifth Report of Session 2007-08, *The Run on the Rock*, HC 56

6 Treasury Committee, Fifth Report of Session 2012-13, *The FSA's report into the failure of RBS*, HC 640 (hereafter cited as HC (2012-13) 640), paras 1-8 and passim; FSA, *The failure of the Royal Bank of Scotland: Financial Services Authority Board Report*, December 2011

7 Treasury Committee, Seventh Report of Session 2008-09, *Banking Crisis: dealing with the failure of the UK banks*, HC 416, paras 39-47, 120-128

4. In July 2011 the Chairman of the FSA wrote to the Chairman of the Treasury Committee describing progress with the Authority's report on RBS and the "extremely valuable" role of the independent reviewers. In view of the public interest in knowing what happened at HBOS, and probably in anticipation of the foreseeable requirement of the Treasury Committee, he said that it was the FSA's intention also to produce a further report on the collapse of HBOS once the enforcement process was complete.⁸ In evidence to the Treasury Committee in January 2012 Lord Turner acknowledged that it had been a mistake on the part of the FSA not to have decided earlier to produce a public accountability report on RBS, and repeated his intention of producing a report on HBOS equivalent to that which the FSA had published on RBS.⁹

5. On 9 March 2012, the Financial Services Authority (FSA) announced that it had completed its investigation of HBOS and that the firm had been guilty of very serious misconduct. Given the exceptional circumstances of the firm being part-owned by the taxpayer, the FSA decided not to levy a fine. Instead the FSA issued a public censure.¹⁰ The FSA concluded its remaining enforcement action in September 2012, through an action in relation to an individual which we consider later in this Report.¹¹

6. In response, the Treasury Committee exercised its powers in a novel way. It wrote to the FSA welcoming Lord Turner's commitment to producing a report into the failure of HBOS, requiring that it be a "comprehensive assessment of the reasons for the bank's failure", and envisaging that the Treasury Committee would appoint external advisers, employed during the drafting process, to provide assurance that the report was a fair and balanced reflection of the evidence.¹² The FSA acceded to this requirement.¹³ The Treasury Committee has recently announced the terms of reference for the independent reviewers, which are to:

- a) review and report on the extent to which the FSA report on the failure of HBOS is a fair and balanced reflection of the available evidence;
- b) review and report on whether the FSA's report is a fair and balanced summary of the Authority's regulatory and supervisory activities in the run up to the failure of HBOS.¹⁴

7. The report by the FSA into the failure of HBOS and the independent review on behalf of the Treasury Committee are unlikely to be published before this Commission publishes its final Report. In order to ensure that a full picture of the UK bank failures in the financial crisis was available to us, we decided to examine HBOS ourselves as a case study of banking failure, in order to identify lessons for our wider work on banking standards and culture.

8 Letter from Chairman of the FSA to Chairman of the Treasury Committee, 11 July 2011, www.parliament.uk/treascom

9 Oral evidence taken before the Treasury Committee on 30 January 2012, HC (2012-13) 640-I, Qq 88,90 190

10 "FSA publishes censure against Bank of Scotland plc in respect of failings within its Corporate Division between January 2006 and December 2008", FSA Press Notice 024/2012, 9 March 2012

11 See paras 130 -135

12 HC (2012-13) 640, para 121

13 *Ibid.*

14 "Treasury Committee appoints specialists to review FSA report into HBOS", Treasury Committee News, 1 March 2013

8. There have been a number of unusual features of the way in which we have carried out our work on HBOS compared with the general working practices of parliamentary committees. In particular:

- a) The Commission appointed Counsel, David Quest and Rory Phillips QC of 3 Verulam Buildings, to participate in the examination of witnesses, the first use of Counsel by a parliamentary committee of this kind;
- b) We gathered a much larger amount of original documentary material than is customary for select committees, including papers of the HBOS Board and correspondence between HBOS and the FSA which would usually be confidential;
- c) We established a panel to undertake the initial phase of our work, led by Lord Turnbull, to collect initial written statements from those invited to give oral evidence and others;
- d) The panel then held 8 meetings between 30 October and 30 November and took evidence from 16 witnesses who had worked for HBOS, served on its Board or been involved in its supervision, enabling evidence to be collected from a broader range of witnesses than can usually be examined by a parliamentary committee for a particular case study;
- e) The panel heard evidence on two occasions from witnesses in private, on one occasion due to the personal circumstances of a witness and on another occasion to maintain the anonymity of a witness from the FSA below executive level;
- f) We deployed high quality bank analysts as staff to assess the evidence on what happened and to provide advice.

In the light of the panel's evidence-gathering, the Commission heard evidence from Sir James Crosby, Chief Executive of HBOS from its creation until 2006, Andy Hornby, its last Chief Executive, and Lord Stevenson of Coddenham, Chairman of HBOS throughout its short life; Counsel also took a lead role in the examination of these witnesses.

9. We are most grateful to all those who assisted us in our work, and in particular to Lloyds Banking Group (LBG) and the FSA for their cooperation on the production of documents, and to Rory Phillips QC, David Quest and their supporting team from 3 Verulam Buildings.¹⁵

10. The work we have undertaken on HBOS will continue to inform our consideration of banking standards and culture in advance of our final Report. We have decided to report separately in advance on HBOS in order to ensure due prominence to some of the lessons from its failure and in order to help shape the agenda for the forthcoming Report by the FSA on the failure of HBOS, the external review of it and subsequent consideration by the Treasury Committee. This Report identifies issues which the FSA should further examine in that Report, but does not contain broader public policy recommendations arising from the case study; these will form part of our final Report.

¹⁵ In addition to David Quest and Rory Phillips QC, Ian Higgins, Kate Holderness and Anne Jeavons of 3 Verulam Buildings were also appointed as specialist advisers for the Commission's work on HBOS.

2 The 'new force in banking'

11. HBOS was created in 2001 from the merger of the Bank of Scotland (BoS) and Halifax. The Halifax had been the UK's largest building society and was one of the last of the major societies to demutualise and float in 1997. At flotation and for the period afterwards, Halifax was almost entirely a retail organisation, and was the leading UK mortgage and savings company, with a 22 per cent share of mortgages and 16 per cent of retail savings. The Halifax profitability and share price stagnated post flotation. It was viewed as having an excessive reliance on mortgage and savings, and the mortgage market in particular was becoming a more competitive area. For Halifax, a deal with BoS offered an almost unique opportunity to transform itself into a broad based commercial bank, particularly in the corporate area.

12. Since the 1970s, BoS had followed a very successful strategy of organic market share growth. The strategy combined maintaining its leading full service market position in Scotland, with targeted expansion in England. The expansion in England involved segments that could be penetrated with 'direct banking' techniques, supplemented by a very limited branch presence. Consequently, the bank prioritised areas such as high value mortgages and deposits and niche segments in the corporate market, including smaller value management buy outs/leveraged loans, asset finance and limited larger corporate banking sectors, notably energy. It also had a significantly higher relative exposure to Commercial Real Estate (CRE).

13. BoS continued to make gains in market share relatively successfully through the early 1990s downturn, which reinforced its confidence in its credit selection procedures. The BoS expansion in England was also primarily, though not exclusively, asset-led and therefore involved a reliance on wholesale funding to support it. By the late 1990s, there were concerns, both among investors and among the bank's management, that the strategy was beginning to stagnate. BoS considered a number of inorganic options. It made a hostile bid for National Westminster Bank, but ultimately lost this battle to its principal Scottish rival, RBS. For BoS, a merger with the Halifax offered the potential of a significantly enhanced balance sheet, from a capital and funding perspective. It was also a relatively complementary merger, with limited overlap. In particular, Halifax had little or no expertise in the corporate and treasury areas, where BoS was expected to provide the basis for the enlarged Group.

14. The creation of HBOS had the effect of turning the 'big four' banking groups into the 'big five'. At the end of 2001, HBOS had total assets of £275 billion, larger than Lloyds TSB and three-quarters of the size of Barclays and of RBS. In its first Annual Report, HBOS described itself as the "new force in banking".¹⁶ The new Group saw an opportunity to benefit from its increased scale and from distributing its broadened product range to an enlarged customer base. It set medium-term targets to achieve product market shares near the 15 to 20 per cent that Halifax had enjoyed in its core markets.

15. The Chief Executive, James Crosby, gave a public target for the new Group to increase the return on equity (RoE) from an underlying figure of 17 per cent in 2001 to 20 per cent

16 HBOS, 2001 Annual Report and Accounts: The New Force

by 2004.¹⁷ This increase implied a target of 80 pence of earnings per share by 2004, compared with the underlying earnings per share of 56 pence per share in 2001. The aim was to achieve this target through rapid growth across all divisions. HBOS essentially achieved this target, with underlying earnings per share of 84 pence and a return on equity of 19.8 per cent in 2004.

16. HBOS sustained significant business growth between its formation in 2001 and 2008, as illustrated by Table 1, which highlights key figures for the Group and its main divisions.

Table 1

	2001	2008	CAGR
	(£bn)	(£bn)	(%)
Group			
Customer Loans	201.0	435.2	12.6
Customer Deposits	140.5	222.3	7.8
Total Assets	274.7	630.9	12.6
Tangible Shareholders Equity (£m)	9,823	17,792 [▼]	10.4
Loans/Deposits Ratio (%)	143	196	
Wholesale funding < 1 year	89.8	119.4	
Leverage (Assets/TSE) (x)	28	35	
Retail			
Customer Loans	132.1	255.3	9.9
Customer Deposits	102.0	143.7	5.0
Corporate (including Business Banking in 2001)			
Customer Loans	55.1	123.0	14.4
Customer Deposits	22.2	38.5	10.5
International			
Customer Loans	14.4	61.0	29.5 [▼]
Customer Deposits	3.7 [▼]	6.6	29.6
Treasury			
Deposits	12.6	33.5	15.0
Insurance & Investment			
General Insurance (Gross Written Premiums) (£m)	1,064	1,799	7.8
Investment Sales	7.79	11.2	5.3

Source Co data and PCBS estimates.

Notes: 2008 Tangible Shareholders Equity figure is end 2007, as 2008 number was depressed by sizable losses.

Corporate growth rates adjusted to exclude impact of business transfers.

International growth rates adjusted to exclude impact of disposals.

Table 1 underlines that, in the period after its creation, HBOS pursued a strategy of asset-led growth, expanding its lending significantly faster than its deposits. Total group loans grew at a compound rate of 13 per cent over the 2001-08 period, excluding the impact of acquisitions and disposals. Customer deposits rose by only 8 per cent per annum during the same period. The growth rate of the loan book was faster up to 2004 than in the years from then until 2008. This slower growth was due to slower retail expansion; there continued to be growth of the corporate and international books, a matter we discuss further in the next chapter. The effect of growth in assets outstripping growth in customer

17 HBOS, 2002 Annual Report and Accounts: 'Even in tough markets, this is the strategy that delivers'

deposits was to increase the bank's reliance on wholesale funding, the consequences of which we explore further later in this Report.

17. According to Colin Matthew, who was successively Divisional Chief Executive of Business Banking and, from 2006, Chief Executive of Strategy and International Operations:

The Board understood the long-term growth strategy and that any strategy involving growth would entail a certain level of risk. For example, the Board recognised the level of exposure to the UK residential and commercial property market.¹⁸

18. Despite pursuing a strategy of high growth with commensurate risk, HBOS preserved the self-image of a conservative institution. Addressing potential funding problems in a private letter to the Chairman of the FSA in March 2008, Lord Stevenson wrote:

The commonsense of the situation is that we are dealing with lenders looking to lend money to a highly conservative institution.¹⁹

This self-image was partially preserved in evidence to the Commission. George Mitchell, Head of the Corporate Division until 2005, said of that period that HBOS was

less conservative than some, but was certainly no more aggressive than many against whom it invariably competed for business.²⁰

Sir James Crosby said of the same period:

The fact of the matter was that we did expand very fast, but the performance of the business in terms of its impairments and risk factors was satisfactory [...] I am not sure I would accept that in the period up to 2005 we had expanded too fast.²¹

Lord Stevenson told us:

This was not an organisation that was obsessed by growth or had a culture of optimism. You can go through the history of any organisation and find decisions that look over-ambitious. If you go through HBOS, you will find quite a lot of decisions that were quite conservative.²²

19. The strategy set by the Board from the creation of the new Group sowed the seeds of its destruction. HBOS set a strategy for aggressive, asset-led growth across divisions over a sustained period. This involved accepting more risk across all divisions of the Group. Although many of the strengths of the two brands within HBOS largely persisted at branch level, the strategy created a new culture in the higher echelons of the bank. This culture was brash, underpinned by a belief that the growing market share was due to a special set of skills which HBOS possessed and which its competitors lacked. The effects of the culture were all the more corrosive when coupled with a lack

18 B Ev w 246

19 B Ev w 534

20 B Ev w 251

21 Q 1275

22 Q 1651

of corporate self-knowledge at the top of the organisation, enabling the bank's leaders to persist in the belief, in some cases to this day, that HBOS was a conservative institution when in fact it was the very opposite. We consider the effects of these cultural weaknesses in the chapters that follow.

3 The avenues to impairment

Introduction

20. Although the Group's strategy was based on aggressive expansion across all divisions, as time went on asset growth was concentrated particularly in areas of higher risk. A bank's lending appears on its balance sheet as an asset. If there is evidence of permanent loss of value, the loan is written down in a process known as impairment. In this chapter, we examine the asset growth in three divisions of HBOS where the assets have subsequently been subject to impairment on a massive scale—the Corporate, International and Treasury Divisions. Further detail about each division is provided in Annexes 1 to 3. We also consider some characteristics of the Retail Division, which is examined further in Annex 4.

Corporate

21. The growth of HBOS's domestic corporate loan book averaged 15 per cent on an underlying basis, adjusted for intra-group transfers, in the period from 2001 to 2008. After an initial period of very rapid expansion—26 per cent in 2002 and 17 per cent in 2003—the growth rate slowed to single figures, but then accelerated sharply to 22 per cent in 2007 and fell back, but still in double figures, to 12 per cent, in 2008. Asset growth ran well ahead of corporate customer deposits, so that the Division's contribution to the funding gap increased from £33 billion at the end of 2001 to £84.5 billion by 2008.

22. HBOS planned to use the BoS corporate expertise and the Halifax branch network to expand its market share among SMEs, particularly in England. The stated ambition in 2001 was to “break the mould” and mount “a strong challenge to the four clearing banks”.²³ In 2004 the Board referred to its plan to make “significant inroads into the market”, although the “Big Four had entrenched, valuable positions”.²⁴

23. The quest for expansion in the face of entrenched positions was even more apparent in relation to larger businesses. In particular, in 2006, Peter Cummings, Chief Executive of the Corporate Division from 2005 to 2008, set the aspiration to “be the best real estate bank in the UK”,²⁵ underpinning an expansion that was focused on property and construction. This sector represented over a third of the Division's customer loans at the end of 2008. Lending for hotels, restaurants and wholesale and retail trade, which would also be significantly property-based, represented a further 10 per cent. Lending to these two categories of business grew significantly faster than the Division as a whole and represented 59 per cent of the net expansion in outstanding loans between 2001 and 2008.

24. In addition to the dominance of property-based investment, there were other characteristics of HBOS corporate lending which contributed to its subsequent demise:

- A close relationship between its conventional business loans, particularly in the property sector, and its provision of equity and leveraged loans, so that customers

23 HBOS, *2001 Annual Report and Accounts: The New Force*, p 24

24 B Ev w 379

25 B Ev w 307

were offered “a complete funding package” including “mezzanine debt and equity” in addition to “more traditional” lending;²⁶

- Large individual credit exposures, expanding rapidly in the later years, so that in September 2002 the largest single name loan approval was £963,000, but by September 2008 the largest single name approval was £2.9 billion and there were nine names in excess of £1 billion;²⁷
- An emphasis on offering loans to be syndicated to others, a strategy which depended upon the continuance of an active market in the syndication of loans; and
- Lowly rated debt, equity and joint venture participations.

25. George Mitchell pinpointed that the corporate market had some characteristics of saturation by the time he left in 2005: “there were clear signs the markets were overheating and it was becoming increasingly difficult to source transactions with the right risk/reward characteristics”.²⁸ In pursuit of expansion, HBOS sought out and found “sub-investment grade” business.²⁹ The FSA pointed out that the Corporate Division had “a specific focus” on sub-investment grade lending and that its “book had a higher risk profile than the equivalent books at the other major UK banking groups”.³⁰

26. One of the most striking features of the Corporate Division’s business was the expansion in its rate of growth in 2007 and 2008 compared with the immediately preceding years. Part of the reason for this was rooted in the culture of HBOS, largely inherited from BoS, which prided itself in “leaning against the wind”—lending through the cycle—maintaining its commitment to customers even in tough times. In October 2007, for example, Peter Cummings said:

Some people look as if they are losing their nerve, beginning to panic even in today’s testing property environment; not us.³¹

Early in 2008, HBOS reported that its commercial property portfolio was “expected to continue to perform relatively well”.³² Peter Hickman, Group Risk Director from September 2007, recollected that the bank made judgements “about maintaining a franchise and about the risk of being seen to be pulling back lending too hard”;³³ he thought that HBOS was “more nervous” about the signals it was sending than “a stronger bank” would have been”.³⁴ Peter Cummings stressed that his actions at the time were more

26 HBOS, *2001 Annual Report and Accounts: The New Force*, p 28

27 B Ev w 437 - 441, 446 - 448

28 BQ 698

29 BQ 716

30 Bank of Scotland, FSA Final Notice, 9 March 2012, para 4.10

31 BQ 1191

32 HBOS, *2007 Annual Report and Accounts: Delivering our strategy...*, p 32

33 BQ 495

34 BQ 496

cautious than his words,³⁵ and there were other factors in the accelerating growth in 2007 and 2008.

27. One factor was the weakness of the syndication market. HBOS acknowledged that it had continued with “strong originations” despite “lower levels of refinancing and sell-down activity”.³⁶ As Peter Cummings put it, the Division was “carrying on while nothing [was] getting sold”,³⁷ leading to what Sir Ron Garrick, the Senior Independent Director at the time, admitted was a “very sharp increase in the loan book in the second half of 2007”.³⁸ Another element was that committed loan facilities extended by HBOS to customers in earlier years were drawn down as borrowers found that other sources of funding, such as the commercial paper market, were no longer accessible to them.³⁹

28. The consequences of the specific characteristics of the HBOS corporate loan book, and the Division’s apparent inability to prevent acceleration in its rate of growth in the second half of 2007 and in 2008, have become evident subsequently. **Although separate reporting for the former divisions of HBOS has ceased since it became part of Lloyds Banking Group, we estimate that aggregate customer loan impairments on Corporate Division loans in the period 2008 to 2011 totalled some £25 billion, equivalent to 20 per cent of the end 2008 loan book, not counting further impairments and write-downs on equity and joint venture investments.**

29. We put to Lord Stevenson the picture that had emerged from our work, including the facilities available and taken up by individuals in the corporate sector by September 2008. He responded:

You cannot look at those provisions and not be horrified and appalled. However, in terms of trying to understand what the truth of the matter is, I think the question I am proposing as to the extent to which they were affected by the closure of wholesale markets and the extent to which there was incompetence is a very real question, which I do not have the ability to measure. But please, please, please, I am not trying to avoid the finger saying that we over-lent in corporate, because we did.⁴⁰

Sir James Crosby told us:

We always believed and my colleagues in the corporate bank always believed that they had a good understanding of the risks they were taking and we in aggregate as a bank had no evidence to the contrary.⁴¹

Having defined competent lending as striking the right balance between risk and reward, Sir James acknowledged, in hindsight, that the bank’s lending had been incompetent.⁴²

35 BQ 1247

36 HBOS, *2008 Annual Report and Accounts*, p 7

37 BQ 1206

38 B Ev w 215

39 BQ 1212

40 Q 1729

41 Q 1347

42 Qq 1348–1350

30. The growth of HBOS's Corporate Division was not the result of superior performance but of its high-risk strategy. The nature of its activities did not alter after the creation of HBOS, although the pace of growth accelerated and the scale significantly increased. When the Division later incurred huge losses, these too were due to the particular nature of its business and resulted directly from its high-risk strategy. Its losses were on a larger proportionate scale than those incurred by any other major UK bank. This was caused specifically by its distinctive loan book, including concentration in commercial real estate and leveraged loans, high exposure to single names, a high proportion of non-investment grade or unrated credit and holdings of equity and junior debt instruments. The loan book was therefore significantly more exposed to the domestic downturn than that of any other large UK corporate banking businesses.

31. The acceleration in loan growth, in part caused by the Division's neglect of the storm signals of 2007 and 2008, is likely to have exacerbated the scale of the subsequent losses. However, even without this acceleration, the Division would still have incurred disastrous losses. The roots of all these mistakes can be traced to a culture of perilously high risk lending. The picture that emerges is of a corporate bank that found it hard to say 'no'.

32. In view of the reckless lending policies pursued by HBOS Corporate Division, we are extremely disappointed by the attempts of the most senior leaders of HBOS at the time to attribute the scale of the consequent losses principally, or in significant measure, to the temporary closure of wholesale markets. The lending approach of the Corporate Division would have been bad lending in any market. The crisis in financial markets was merely the catalyst to expose it. Losses in the Corporate Division did not prove temporary. Indeed, we estimate that the HBOS Corporate loan book has continued to incur significant impairments in every year since 2008, demonstrating that the losses were the result of incompetent lending and not caused solely by the events of 2008. Furthermore, HBOS's Corporate Division was significantly more exposed than other banks to the downturn in the economy due to the nature of its loan book.

International

33. HBOS was, at the time of its creation and in its early years, a largely domestic bank. This was regarded within HBOS as a source of weakness,⁴³ and, particularly from 2004 onwards, HBOS sought to grow aggressively abroad, building on what it believed to be its areas of expertise in UK markets, and concentrating particularly in Ireland and Australia.⁴⁴ The Board set ambitious targets for market share gains from strong local incumbents.⁴⁵

34. The fastest growth took place in Ireland, where HBOS aspired to become "the No. 1 business bank during 2005",⁴⁶ with the overall strategic goal of becoming "the fourth largest

43 B Ev w 233; Q 1558

44 B Ev w 233, 247; HBOS, *2005 Annual Report and Accounts*

45 B Ev w 404, 415

46 B Ev w 390

full service Irish bank by 2009".⁴⁷ In particular, HBOS sought to grow its corporate business in Ireland. Many of the characteristics that facilitated rapid growth were shared with the UK corporate book: an increasing concentration on property and construction; and the use of "asset specific transactions", again concentrated in the commercial real estate and related sectors.⁴⁸ As in the UK, loan growth continued in 2008, in Ireland at a rate of 8 per cent in constant exchange rate terms, growth which Colin Matthew attributed to the draw downs of existing facilities, the inability to sell down and the residential property pipeline.⁴⁹

35. Similarly, in Australia, HBOS sought to double its national market share and to be a new rival to the four local banks that dominated the market.⁵⁰ By June 2006, Colin Matthew was telling the top management that the longer term aim for the Australian business "was to become a major Australian financial services company with market shares in the 15–20 per cent range in chosen segments".⁵¹

36. In Ireland, estimated impairments between 2008 and 2011 totalled £10.9 billion, equivalent to 36 per cent of the loan book at the end of 2008; 60 per cent of impaired loans in Ireland at the end of 2011 related to exposures to commercial real estate. All leading Irish banks incurred significant impairments, as a result of the Irish recession. However, the losses at HBOS as a proportion of loans were greater than those of all but one of the major Irish banking groups, as Table 2 shows:

Table 2
Leading Irish Banks' Cumulative Loan impairments
(2008-11 as % of end 2008 loans)

AIB	22.1
Anglo Irish	48.3
Bol	9.4
Danske	17.9
HBOS	35.5
ILP	6.1
KBC	6.7
Ulster	17.5

Source: Company data

37. In Australia, the impairments over the same period totalled £3.6 billion, equivalent to 28 per cent of the value of the loan book there at the end of 2008, an even higher loss as a proportion of loans than incurred by the Corporate Division in the UK. This loss is all the more striking in view of the comparative resilience of the Australian economy in the global downturn: in this period, the Australian banking sector remained profitable and no entities received any public capital support during the crisis.⁵²

47 B Ev w 420

48 HBOS, *2007 Annual Report and Accounts: Delivering our strategy...*, pp 53-54

49 BQ 151

50 B Ev w 391-392

51 B Ev w 298

52 Financial Stability Board, *Peer Review of Australia: Review Report*, September 2011, p 5

38. Sir James Crosby accepted that the losses in Australia were indicative of an appalling lending record,⁵³ but sought to defend the Irish impairments by reference to the “extraordinarily difficult conditions” that that market experienced.⁵⁴ Andy Hornby accepted that the growth in Ireland was “mistaken”, but defended at least the retail element in Australian growth, while acknowledging:

It was difficult to grow as quickly in retail banking as in corporate banking because it takes so much longer to build franchise-built deposit bases and build scale.⁵⁵

Lord Stevenson emphasised the excellence of the team HBOS had in Australia and the time he and the main Board had devoted to growing that business. When asked about the level of impairments that developed, he said:

I cannot distinguish between the loss of value reflected by the knock-on effects of the closure of wholesale markets and the knock-on effect from bad lending decisions in any markets. That it is a horrible figure is beyond doubt.⁵⁶

39. Abroad as at home, HBOS took what it saw as the relatively quick and easy path to expansion without acknowledging the risks inherent in that strategy. As in the UK, HBOS concentrated on sectors which enhanced the intensity of its subsequent exposure. In two markets alone—Australia and Ireland—it incurred impairments of £14.5 billion in the period from 2008 to 2011. These losses were the result of a wildly ambitious growth strategy, which led in turn to significantly worse asset quality than many of its competitors in the same markets. The losses incurred by HBOS in Ireland and Australia are striking, not only in absolute terms, but also in comparison with other banks. The HBOS portfolio in Ireland and in Australia suffered out of proportion to the performance of other banks. The repeated reference in evidence to us by former senior executives to the problems of the Irish economy suggests almost wilful blindness to the weaknesses of the portfolio flowing from their own strategy.

Treasury

40. As we noted in our First Report, one of the characteristics of the years leading up the financial crisis was the transformation of treasury functions within UK banks from their traditional role of funding safely profit-generating activity elsewhere in the business to being profit-centres in their own right.⁵⁷ HBOS viewed its Treasury Division as relatively conservative, and it ceased its interest rate proprietary trading activities in 2005, but it was not immune from this weakness.⁵⁸ The Division consistently maintained significant liquidity, partly in recognition of the Group’s substantial use of wholesale funding. Initially, this liquidity was invested in government bonds and bank certificates of deposit.⁵⁹

53 Q 1293

54 Q 1292

55 Q 1463

56 Q 1558

57 Parliamentary Commission on Banking Standards, First Report, HC (2012–13) 848 and HL Paper 98 of Session 2012–13 (hereafter cited as First Report), para 39

58 B Ev w 242-244

59 BQ 593; B Ev w 385-386

However, from 2004, a strategy was agreed to reduce its perceived over-reliance on these types of holdings. The Board was told in May 2004 that new products such as credit derivatives “would have superior returns and liquidity characteristics” and would “leverage expertise to create income”.⁶⁰ The Division had also inherited a portfolio of structured credit assets from Halifax and these roughly doubled over the life of HBOS, as the liquidity portfolio was diversified. The Division held an increasingly significant proportion of its assets via conduits, the most significant of which (Grampian) held half of the Group’s asset-backed securities investments.

41. The Executive Committee understood that there was greater risk inherent in the move to instruments with higher returns,⁶¹ although some members of the Board may not have done so, judging by Jo Dawson’s (Group Risk Director in 2004-05 and subsequently Group Board member and Head of Insurance & Investment Division and Retail Distribution) admission that she “would not have known what an Alt-A security was”.⁶² Immediately after the creation of HBOS, the Head of the Treasury Division was a member of the main Board, but his successors were not, reporting via heads of other divisions whose asset growth relied on the funding which the Treasury Division was charged with raising.

42. As the financial crisis hit, the HBOS Treasury Division turned from a source of profit to another source of loss. The aggregate profit and loss charges attributable to the Division in the period from 2008 to 2011 totalled £7.2 billion. Losses on this scale alone would have required recapitalisation of the Group. All relevant functions at HBOS, from the Board downwards, did not properly understand the nature of the risks embedded in the Treasury Division’s structured investment portfolio, either from a credit risk or liquidity perspective.

43. Far from providing liquidity and offering some protection against the Group’s use of wholesale funding, the liquidity of the portfolio evaporated when the financial crisis developed, substantial losses were incurred as a result of a sharp decline in market valuations and the size and nature of the securities portfolio served to increase market concerns towards HBOS. The bank was, of course, far from unique in incurring losses in structured investments; many other banks, both in the UK and in other countries, also incurred such losses. However, HBOS was excessively confident that its understanding of UK residential mortgages and related securitisations gave it the ability to understand and evaluate the risks in a wide range of asset-backed investments.

Retail

44. The Retail business was the largest division in HBOS in terms of customer loans. A key element of the Division’s mortgage strategy was to grow ‘non-standard’ mortgage lending, particularly buy-to-let and self-certified mortgages, where margins had remained higher than for standard mortgages and the overall profitability was thought to be more attractive, despite higher credit risks. By the end of 2008, £66.5 billion (28 per cent) of the banks’ retail mortgage lending was classified as non-standard and 62 per cent of the Division’s book had

60 B Ev w 385

61 B Ev w 302

62 BQ 270

a loan-to-value ratio of over 70 per cent.⁶³ These proportions are significantly higher than for any other mainstream mortgage lender. Furthermore, at the end of 2008, the Retail Division had customer deposits of £144 billion and customer loans of £255 billion, a gap of £111 billion⁶⁴ which accounted for over half the Group's total funding gap of £213 billion.⁶⁵

45. LBG does not publish divisional results for the HBOS Group and so it is not possible to know precisely the impairments the Retail Division has incurred since the financial crisis. We do, however, know that at the end of 2008, HBOS had retail impairments of £2.2 billion, of which £1.1 billion was against secured lending,⁶⁶ up from just £28m in 2007. We estimate that total Retail impairments would have been some £7 billion between 2008 and 2011.

46. **The impairments incurred by the Retail Division were substantially less than those incurred by the Corporate and International Divisions and were not a material factor in the failure of HBOS. The Retail Division is likely to have remained profitable during the crisis period and subsequently, albeit at a reduced level. We note, however, that the Division incurred substantially higher mortgage-related losses than its major competitors, reflecting the bank's strategy of pursuing growth in higher risk non-standard mortgages. We also note that the Division's customer funding gap was a major factor in the Group's overall funding gap, which was a principal immediate cause in the short term of the failure of the bank. Prudent customer funding should have been a secure source of stability during market storms.**

Overall conclusions

47. **The massive impairments in HBOS were not confined to a single division. In the case of the Corporate Division, the impairments of £25 billion on their own would have threatened the ability of the bank to operate or require complete recapitalisation. The impairments in the International Division of £15 billion set HBOS apart among its comparators and, although smaller than in the Corporate Division in absolute terms, were larger as a proportion of the loan book. They too would have been sufficient on their own to necessitate substantial recapitalisation. The losses in the Treasury Division of £7 billion would also have been sufficient on their own to require recapitalisation. Both the relative scale of such large losses and the fact that they were incurred in three separate divisions suggests a systemic management failure across the organisation. Taken together, the losses in these three divisions would have led to insolvency.**

63 HBOS, 2008 Annual Report and Accounts, p 124

64 *Ibid.*, p 47

65 *Ibid.*, p 42

66 *Ibid.*

4 A failure of internal control

The weaknesses of the federal model

48. HBOS operated a federal model. With the exception of the Treasury Division from 2004, each of the divisions whose operations we referred to in the previous chapter and the Insurance & Investment Division operated with their own Chief Executive and their own divisional management and risk and control structures. Day-to-day management of the Group was delegated to the Group Management Board, subsequently renamed the Executive Committee (ExCo). ExCo comprised the Group Chief Executive and the Finance Director, along with the divisional chief executives and other, selected senior executives.

49. Each division was formed by combining activities of the two constituent banks. The lead role was assumed by the stronger partner in the relevant area. Former Halifax management led the Retail and Insurance & Investment Divisions, while former BoS executives led the Corporate and Treasury Divisions, as well as the International Division from 2004. The Group's two Chief Executives both came from the retail side, Sir James Crosby from the previous Halifax leadership and Andy Hornby recruited to head the Retail Division in the first instance. Large exposures required an additional executive director to sign them off, but because Colin Matthew (International) and Peter Cummings (Corporate) were recognised as having the most corporate expertise, they were largely responsible for signing off each other's exposures.⁶⁷

50. Jo Dawson felt that the level of internal challenge to the divisions was "quite low".⁶⁸ She said that she understood ExCo to be an "advisory committee whose role was to support" the Group Chief Executive; the authority to challenge executive directors rested with the Group Chief Executive, supported by the Finance Director.⁶⁹ Peter Hickman shared this view.⁷⁰ With regard to the Corporate Division, Mike Ellis admitted that the challenge process at Group level did not necessarily involve people with direct corporate banking experience.⁷¹ Peter Hickman said that the senior management of HBOS clearly had a lot less understanding of corporate banking than the divisional managers and that there was "huge degree of trust" in Peter Cummings's judgement.⁷² Andy Hornby admitted that most of his focus was on other areas because "there were other parts of the business that were causing us more concern in terms of the risk profile than corporate lending".⁷³

51. Risk Assurance was provided by internal control functions, including the Audit Committee and Internal Audit. Divisional Risk Control Committees (RCCs), distinct from the divisional risk committees, reported to the Audit Committee and comprised two non-executive directors, an executive director from another division, and a member otherwise external to the HBOS Group. The RCCs were the result of an initiative from the Chairman,

67 BQ 1278 and B Ev w 248

68 BQ 259

69 B Ev w 195; BQ 238

70 BQ 505

71 BQ 315

72 BQ 506

73 Q 1446

who believed they examined all the risks present in their area.⁷⁴ Anthony Hobson, Chairman of the Group Audit Committee from 2001 to 2008, considered that the RCCs had the dual advantage of giving non-executive directors direct exposure to risks in individual divisions and executive directors knowledge of risks in other parts of the Group.⁷⁵ Andy Hornby indicated that he “relied very much” on the RCCs and their composition.⁷⁶

52. However, Anthony Hobson regarded the function of the Audit Committee as more backward than forward looking, which was in his view more the responsibility of the executive risk committees. He regarded the RCCs as effectively performing the role of divisional audit committees in their role, compared with the executive divisional risk committees.⁷⁷

53. The HBOS Group operated a federal model, with considerable independence given to the divisions. Central challenge to the divisions from senior executive management appears to have been inadequate in the case of the three divisions that ultimately caused the most significant losses (Corporate, International and Treasury). HBOS senior management derived from Halifax and the Retail Division. Accordingly, their understanding of retail banking was stronger, and their relative weakness in other areas meant that their reliance on divisional management in the corporate banking areas was greater. The key role of assessing exposure to future credit risks was dominated by the executives of the individual divisions. These weaknesses in senior management were instrumental in the pursuit by these three divisions of the policies and practices that led to devastating losses.

The group risk function

54. The weaknesses of executive control could perhaps have been mitigated by an effective risk function at Group level, but the Group Chief Executives did not develop a strong Group-level risk function. Paul Moore took up a post as Head of Group Regulatory Risk in late 2003, but said that he met resistance to his proposed approach to the management of risk. The main reporting line of the divisional risk functions was to the divisional management rather than to the group risk function. Paul Moore said that this

created a kind of ‘us and them’ culture between the group risk functions and the divisional risk functions, which was dysfunctional.⁷⁸

He also detected what he termed a “cultural indisposition to challenge”.⁷⁹

55. In early 2003, Sir James Crosby wrote to the FSA accepting “the need to make more progress in some areas, notably the relationship between group risk and divisional risk functions”.⁸⁰ In evidence to us, Sir James rejected Paul Moore’s characterisation of the

74 Q 1629

75 BQ 937

76 Q 1468

77 BQ 939

78 BQ 7

79 BQ 40

80 B Ev w 469

relationship as “dysfunctional”,⁸¹ and his chosen solution at the time involved creating a new role of Group Risk Director, going through “a good succession planning process” and concluding that “somebody else other than Paul Moore was better qualified to head that function” in consequence of which Mr Moore was made redundant.⁸²

56. The new post of Group Risk Director was held by Jo Dawson for 14 months before she was promoted to Head of the Insurance & Investment Division. Her successor, Dan Watkins, was Group Risk Director for less than a year before also being promoted to Head of Retail Products and being appointed to the Board. He in turn was succeeded by Peter Hickman. Jo Dawson had held senior positions in the Retail Division before taking up her post, but had no market or large corporate experience;⁸³ Dan Watkins had worked in the Morgan Grenfell treasury and become Managing Director of Birmingham Midshires, which undertook higher risk mortgage lending for HBOS. Peter Hickman was previously director of group finance.

57. During her brief time in the role of Group Risk Director, Jo Dawson concluded that she had influence rather than authority. Her ability to effect change was dependent on her relationship with the divisions.⁸⁴ This arrangement essentially reflected the very weakness that the creation of the post was, according to Sir James Crosby at the time, designed to address. When Jo Dawson raised concerns from competitors that the Corporate Division was too aggressive from a risk perspective, her recollection was that the Chairman and Chief Executive said that they were comfortable with the position and that competitors were “mudslinging”.⁸⁵ Peter Hickman saw his role as more than advisory, but acknowledged that the seniority of his post relative to that of the divisional heads was an issue.⁸⁶

58. When we asked Eric Daniels, Chief Executive of Lloyds TSB at the time of the takeover of HBOS, for his reflections on the difference in the culture of the two organisations, he highlighted the difference in approach to Group risk functions:

My observation would be that HBOS had a desire to grow rapidly and they were seemingly able to pull off growth within acceptable risk parameters—seemingly [...] I think it was a question of having an ambitious set of growth goals without having some of the experience and moderating influences in many of the cases [...] In HBOS [the group risk role] was viewed more as a rotational set of assignments to round out people. So rather than getting experts, they would bring in people as development experiences.⁸⁷

He accepted the possible benefit of senior managers aspiring to run a bank serving in risk positions at an earlier stage in their career, but not at the most senior level of risk:

81 Q 1386

82 Q 1388

83 BQ 216

84 BQq 217, 233, 234; B Ev w 194

85 BQ 253

86 BQq 489 – 92, 507

87 Q 4293

I do not believe that you can put talented amateurs in some of these positions, no matter how smart the individuals are. You really need deep professionalism, especially in today's environment: the sophistication of financial products and the ways in which things can go wrong are that much greater than in the good old days.⁸⁸

59. Sir James Crosby told us that his aim in creating the position of Group Risk Director was to enhance its profile and “enhance the position in the context of the Group”.⁸⁹ He nevertheless conceded that it was “unusual” that two successive holders of the new post had no specific experience in risk functions.⁹⁰ Indeed, he conceded that it could be characterised as “bizarre”.⁹¹ Lord Stevenson agreed that the rapidity with which Jo Dawson moved on from the risk function was “less than desirable”,⁹² but said that it reflected “the philosophy of trying to give our outstanding executives experience of the risk function”.⁹³

60. Seeking to draw lessons from his experience in HBOS, Andy Hornby told us:

In big, diverse banks, to have a technically strong and personally adept group risk director is totally crucial because to be able to see through the various trends to what the really big things are that need to be challenged is utterly crucial. Secondly, I believe that it is easier if the divisional risk teams have a straight-line reporting relationship to the group risk director, as that takes away an element of potential tension. Ultimately, though, however good your credit risk assessors, divisional risk teams and group risk teams may be, you need to ensure that there is a proper culture of welcoming challenge from the risk teams. That is [the] responsibility of the entire board, and that has to be constantly emphasised.⁹⁴

61. Sir James Crosby and Jo Dawson indicated that the prime responsibility and expertise for risk management and credit assessment rested with the individual divisions, while group risk functions set overall policy and standards, provided functional leadership and oversight and undertook reviews of certain issues.⁹⁵ In particular, the divisions had sole responsibility for individual credit sanctioning, with no involvement at Group level. The Corporate Division in particular had a strong sense of its ability to source good quality assets. Jo Dawson indicated that Corporate was less open to challenge and that it did not believe Group functions had the expertise to advise it.⁹⁶ George Mitchell regarded the function of Group Risk as concerning “macro issues” such as sector limits, approval processes, policies and the bank's readiness for Basel II.⁹⁷ However, the view of the Corporate Division was that individual counterparty assessment was the most important judgement in credit risk.⁹⁸ It therefore requested headroom in sector limits, so as to have

88 Q 4294

89 Q 1425

90 Q 1422

91 Q 1423

92 Q 1742

93 Q 1756

94 Q 1513

95 BQq 204, 206, Q 1392

96 BQq 222, 227

97 BQ 675

98 BQ 507

the flexibility to lend on the basis of its assessment of individual counterparty risk, rather than being constrained.⁹⁹ This effectively rendered sector limits meaningless.

62. Both Peter Hickman and Jo Dawson said that the Corporate Division had great confidence in its credit expertise, partly because it had not only weathered previous downturns but had also benefited from them. Peter Hickman acknowledged that he had had “quite full debates” with Dan Watkins, then in charge of Retail on specialised mortgage lending risks, “probably helped by the fact that he had been a group risk director”.¹⁰⁰ In contrast, Corporate Division was more confident in its own credit assessments.¹⁰¹

63. Group senior management and central risk functions had greater understanding of the Retail business and several of them had direct expertise of working on the Retail side. There was therefore greater involvement by senior management and central functions in Retail and greater willingness to accept that on the part of the Division. By contrast, there was much more limited challenge and ability to challenge Corporate, International and Treasury activities and also, on the part of Corporate at least, willingness to accept it.

64. The risk function in HBOS was a cardinal area of weakness in the bank. The status of the Group risk functions was low relative to the operating divisions. Successive Group Risk Directors were fatally weakened in carrying out their duties by their lack of expertise and experience in carrying out a risk function, by the fact that the centre of gravity lay with the divisions themselves rather than the group risk function, and by the knowledge that their hopes for career progression lay elsewhere in the bank. The degradation of the risk function was an important factor in explaining why the high-risk activities of the Corporate, International and Treasury Divisions were not properly analysed or checked at the highest levels within the bank.

65. The weaknesses of group risk in HBOS were a matter of design, not accident. Responsibility for this lies with Sir James Crosby, who as Chief Executive until 2005 was responsible for that design, with Andy Hornby, who failed to address the matter, and particularly with Lord Stevenson as Chairman throughout the period in question.

99 BQ 507

100 BQ 493

101 BQ 489

5 A failure of regulation

The FSA's initial identification of weaknesses

66. As well as analysing evidence on the internal running of HBOS, we have gathered and assessed evidence on the role of the FSA in the history of HBOS and the relationship between the two.

67. There was an initial phase in the FSA's regulation of HBOS, lasting until the early months of 2004, when the FSA successfully pinpointed some of the key weaknesses in the HBOS strategy and business design. Late in 2002, an FSA review identified serious concerns about the Group's control functions, including the possibility that controls were not keeping pace with growth, that the group risk function was insufficiently embedded in the business and that the bank was over-reliant on wholesale funding. The HBOS Board was told by the FSA of its need for a "robust plan" to ensure adequate access to wholesale funding while the growth in the Retail and Corporate Divisions' assets outstripped growth in deposits.¹⁰²

68. Towards the end of 2003 the FSA expressed concern about the failure by HBOS properly to address the findings of the 2002 review. The failings included a failure of the control framework to keep pace with asset growth, a lack of articulated risk appetite and insufficient embedding of the group risk function. The FSA's concerns were such that it increased the capital requirement on the bank by 0.5 per cent to 9.5 per cent.¹⁰³

69. The FSA also identified a number of specific concerns about the control environment in the Corporate Division, based on a review by the FSA's credit risk specialists. These concerns included:

- A lack of clarity about the point at which management would cease to feel comfortable about increasing the exposure to commercial property;
- Deficiencies in the credit sanctioning process;
- The lack of a reliable risk grading system;
- Weaknesses in the procedures for selling down exposures (the loan distribution process), creating a risk of exposure in the event of a failure to sell down if and when conditions deteriorated.

The issues identified by the FSA late in 2003 led directly to the discussion at the Board on 22 January 2004 to which we referred at the start of this Report, when the FSA was reported as viewing HBOS as an "accident waiting to happen".

The reduction of regulatory pressure

70. A number of reviews were commissioned in response to the FSA's concerns. HBOS Group Financial Risk and KPMG reviewed the credit processes for the Corporate Division.

102 B Ev w 450

103 B Ev w 476

The FSA commissioned PwC to undertake a so-called 'skilled persons review' under section 166 of the Financial Services and Markets Act 2000 on the Group's control framework and risk management processes. The reports made a number of recommendations for change, but the second report concluded that the risk management processes within HBOS in general, appeared "to work well".¹⁰⁴ Within HBOS, George Mitchell also interpreted the skilled persons report as an indication that "the risk management control framework was effective and satisfactory" and said that he was "comfortable with the control environment".¹⁰⁵

71. From this point onwards, the regulatory pressure for improvement appears to have diminished.¹⁰⁶ The FSA took considerable comfort from the reviews and reversed the increase in the capital requirement in December 2004, which sent a strong positive message to HBOS that they were moving in the right direction.¹⁰⁷ An ARROW review in late 2004 noted that HBOS's risk profile had improved and that it had made good progress in addressing the risks highlighted previously, but the group risk functions still needed to enhance their ability to influence the business.¹⁰⁸ Clive Briault, the FSA's Managing Director, Retail Markets 2004-08, said:

The supervisory judgement at the end of 2004, as was communicated to the firm, was that sufficient comfort was taken by the supervisors from the conclusions of the skilled persons report, which I believe was sent to the FSA in the summer of 2004, and by the progress evidenced through their contact with HBOS during the year on a range of other issues and also, perhaps I should just add in the context of the skilled persons report, the acceptance by HBOS that it would carry forward the recommendations contained in the skilled persons report.¹⁰⁹

The change in regulatory focus

72. From the evidence we have gathered on the subsequent phase of FSA regulation, it is all too apparent that the FSA switched its focus from late 2004 away from the prudential risks inherent in the Group's business model to two other regulatory preoccupations—implementation of Basel II and the FSA's Treating Customers Fairly (TCF) initiative. By 25 July 2006, Dan Watkins was able to tell the Board that the latest review from the FSA was "a generally positive assessment" and that:

The FSA was comfortable to place increasing emphasis on senior management to ensure that business and control risks were properly identified and mitigated.¹¹⁰

In October 2007, an evaluation by the FSA of points raised in its previous ARROW reviews concluded that many of the issues had been addressed and could be closed. The evaluation

¹⁰⁴ PwC, *HBOS plc: Skilled persons Report under Section 166 of the Financial Services and Markets Act ('FSMA') (2000)*, July 2004

¹⁰⁵ BQ 728

¹⁰⁶ B Ev w 392

¹⁰⁷ B Ev w 492

¹⁰⁸ *Ibid.*

¹⁰⁹ BQ 1087

¹¹⁰ B Ev w 413

stated, for example, that “HBOS has prudent corporate credit provisions in place. Issue closed.”¹¹¹ However, the FSA Final Notice on BoS on 9 March 2012 provides evidence that issues were in fact unresolved.¹¹²

73. A huge amount of regulatory time and attention, in relation to HBOS as with other banks, was devoted to the Basel II model approval process, whereby banks could apply for a waiver to be permitted to use their own internal models to calculate capital adequacy requirements. HBOS attached importance to obtaining the so-called ‘advanced status’, because it would potentially enable them to hold a lower level of regulatory capital. The minutes of the HBOS Board meeting on 24 June 2003 state that:

“Advanced” status was the only credible status for HBOS. It was an essential defence against competitive erosion and a key weapon in driving competitive advantage. “Advanced” banks would have the capacity to undercut competition on chosen tranches of business, with cost of capital being a key strategic weapon.¹¹³

74. Jo Dawson told the Board in March 2005, “the Group was likely to be a relative ‘winner’ compared with the peer group”.¹¹⁴ She subsequently reported to the HBOS Executive Committee in May 2005 that: “The advanced approaches to credit and operational risk would bring financial benefits (potentially major in terms of capital requirements, although this was yet to be proven)”.¹¹⁵

75. In June 2007, the month in which Northern Rock was granted a Basel II waiver,¹¹⁶ the HBOS application was not granted by the FSA. The HBOS application was then granted in September 2007, subject to conditions that needed to be satisfied by 1 January 2008. Michael Foot (the FSA Managing Director for Deposit Takers and Markets 1998-2004) described Basel II as “immensely complex and immensely resource demanding” and “a complete waste of time”.¹¹⁷ At the time, Lord Stevenson said that HBOS staff had devoted “tens of thousands of hours” to try and secure its Basel II waiver,¹¹⁸ and Andy Hornby conceded that the process was a “huge distraction”.¹¹⁹

76. Although the FSA had initially identified HBOS’s reliance on wholesale funding as a concern, the regulator’s attention to liquidity weakened dramatically between 2004 and 2007. Ironically, HBOS itself seemed more aware of the deficiencies than the regulator. On 1 March 2005, the Board was told:

Liquidity [...] remained a significant management challenge. HBOS was structurally illiquid: this needed to be overcome through ensuring sources of funds were appropriately diversified, with identified additional capacity in case of need. There

111 B Ev w 527

112 Bank of Scotland, FSA Final Notice, 9 March 2012, paras 2.7 – 2.19

113 B Ev w 355

114 B Ev w 405

115 B Ev w 288

116 Treasury Committee, Fifth Report of Session 2007-08, *The Run on the Rock*, HC 56, para 43

117 BQ 1074

118 B Ev w 525

119 Q 1484

were no global regulatory standards in relation to the holding of liquidity. The FSA's current regime was weak: There were intentions to improve these requirements, to look at the issue in an international context, but these were unlikely to be effective until 2008.¹²⁰

77. Clive Briault accepted that too much prudential supervision between 2004 and 2006 was devoted to capital rather than liquidity.¹²¹ He also drew attention to the fact that, following push back from the industry, the FSA Board had chosen not to pursue quantitative liquidity requirements at a national level until the outcome of international work on liquidity was clearer.¹²² The FSA only focused again on the threat to HBOS from lack of liquidity late in 2007, writing to HBOS on 21 December 2007:

We expect HBOS to stress test the ability to access wholesale funding markets and for this exercise to be complete by January 2008. Due to the recent market conditions and your reliance on wholesale funding, we have increased our liquidity monitoring which will continue for the foreseeable future. We also expect HBOS to carry out analyses of funding maturities and funding diversification – wholesale and deposits, to ascertain key dependencies.¹²³

78. In June 2008, the FSA looked again at the credit risk management issues in the Corporate Division that it had identified in 2003. In October 2008, the FSA wrote to Peter Cummings to inform him that the review had identified:

Shortcomings in the sphere of credit risk management and processes. For example; challenge in credit decisions is not always evident; management information, while developing, has a considerable way to go before it can be relied on for managing the book; the quality and timeliness of data use for risk management needs improving; portfolio management is in its infancy; procedures and processes for syndications/sell downs need strengthening.¹²⁴

79. Although the FSA had shown an intermittent interest in credit controls, it paid far less attention to analysis of asset quality itself. According to one of the FSA staff responsible for regulating HBOS:

At the time, a lot of the work that was done in terms of reviewing credit quality did not involve a hands-on, detailed assessment of the books or the individual credits themselves, so it wasn't deep dives. A lot would have been done in terms of reviewing the regulatory returns or the published financial returns and some degree of stress testing or peer comparability across firms. But in hindsight, that was nowhere near sufficient to be able to get to grips with the actual quality of the underlying assets within the book.¹²⁵

120 B Ev w 402

121 B Ev w 177

122 B Ev w 179 -180

123 B Ev w 531

124 B Ev w 558

125 BQ 1421

Clive Briault confirmed that the FSA was more concerned at that time with systems and controls than with the “quality of individual loans on the loan book”.¹²⁶

The scale and level of FSA engagement

80. The team responsible for the supervision of HBOS was located within the Major Retail Groups Division at the FSA. The team reported to a Head of Department who had responsibility for the supervision of around 15 groups, spanning large banks, insurance firms and asset managers. The team comprised a manager and five staff (although it increased in size from late 2007 in response to the financial crisis). As well as supervising HBOS, the team supervised one or two other smaller retail groups, but the majority of their time was spent on HBOS. The team was responsible for the oversight of both prudential and conduct issues and was able to call on risk specialists within the FSA in areas such as credit, market, operational and insurance risk, conduct risk and financial crime. Day-to-day contact with HBOS was primarily undertaken by the manager of the team, including communications with the Board following the FSA’s formal risk assessment reviews.¹²⁷ Those at the most senior levels within the FSA, such as the Managing Director and Director with responsibility for the supervision of HBOS, had very little direct contact with the firm.¹²⁸

The attitude of HBOS management to the regulator

81. In the early phase of the short corporate life of HBOS when the FSA identified key weaknesses in the control environment, it met with complaints from the bank. When the FSA spelled out its concerns about the Corporate Division late in 2003, George Mitchell replied that he was “extremely disappointed by the overall tone of your letter and indeed find many of the comments and findings to be unfair”.¹²⁹ The Audit Committee rejected the FSA’s findings that growth had outpaced the control framework and encouraged a response that should be “measured and robust”.¹³⁰

82. When HBOS was informed that its Basel II waiver would not be granted in June 2007, Lord Stevenson wrote to the Chairman of the FSA in intemperate terms, questioning whether there might be “any legitimate grounds for concerns about the consistency, the proportionality or the fairness of the process”.¹³¹ As late as 1 August 2008, Andy Hornby wrote to the FSA, from what he saw as a position of capital strength, to warn against “excessive conservatism” on the part of supervisors.¹³² Despite such communications, in the words of David Strachan, FSA Director of Major Retail Groups 2006-08:

126 BQ 1102

127 B Ev w 268

128 B Ev w 174

129 B Ev w 471

130 B Ev w 283

131 B Ev w 525

132 B Ev w 557

the FSA judged HBOS plc to have an open and constructive relationship with it [...] This resulted in the FSA placing reliance on HBOS plc's senior management to deliver some actions within the Group's risk mitigation programme.¹³³

Conclusions

83. The picture that emerges is that the FSA's regulation of HBOS was thoroughly inadequate. In the three years following the merger the FSA identified some of the issues that would eventually contribute to the Group's downfall, notably the risk that controls would fail to keep pace with aggressive growth and the Group's reliance on wholesale funding. The FSA failed to follow through on these concerns and was too easily satisfied that they had been resolved. The FSA took too much comfort from reports prepared by third parties whose interests were not aligned with those of the FSA.

84. From 2004 until the latter part of 2007 the FSA was not so much the dog that did not bark as a dog barking up the wrong tree. The requirements of the Basel II framework not only weakened controls on capital adequacy by allowing banks to calculate their own risk-weightings, but they also distracted supervisors from concerns about liquidity and credit; they may also have contributed to the appalling supervisory neglect of asset quality. The FSA's attempts to raise concerns on these other fronts from late 2007 onwards proved to be a case of too little, too late.

85. In our First Report, drawing upon evidence from Sir Mervyn King, we emphasised the need for regulators to be able to exercise judgements in their supervision of banks without feeling that they were engaged in a process of negotiation.¹³⁴ **The experience of the regulation of HBOS demonstrates the fundamental weakness in the regulatory approach prior to the financial crisis and as that crisis unfolded. Too much supervision was undertaken at too low a level - without sufficient engagement of the senior leadership within the FSA. The regulatory approach encouraged a focus on box-ticking which detracted from consideration of the fundamental issues with the potential to bring the bank down. The FSA's approach also encouraged the Board of HBOS to believe that they could treat the regulator as a source of interference to be pushed back, rather than an independent source of guidance and, latterly, a necessary constraint upon the company's mistaken courses of action.**

86. Regulatory failings meant that a number of opportunities were missed to prevent HBOS from pursuing the path that led to its own downfall. The priorities of the supervisor also reinforced the senior management of HBOS in their own misplaced priorities. Ultimate responsibility for the bank's chosen path lies, however, not with the regulator but with the Board of HBOS itself.

133 B Ev w 266

134 First Report, paras 132-133

6 'The best board I ever sat on'

The qualities and experience of the Board

87. Sir Ronald Garrick was a non-executive director of BoS from March 2000, joined the HBOS Board when it was formed and served as Deputy Chairman from December 2003 and Senior Independent Director from 2004. He had this to say on his experience on the Board of HBOS:

I have no doubt that the HBOS Board was by far and away the best board I ever sat on. My recollection of the culture and characteristics of the Board was one of openness, transparency, high intellect, integrity, good working relationships between the Chairman and Chief Executive, and a suitable diversity of backgrounds, mix of experience and expertise to maximise effectiveness [...] If with the benefit of hindsight I was asked if I wanted to sit on this board again I would be saying yes.¹³⁵

Sir James Crosby said that a "lot of consideration" was given to the make-up of the HBOS Board to ensure an appropriate balance of skills.¹³⁶ He considered that the non-executive directors had the right range of skills to reflect their responsibility for a diverse financial services group:

Overall, I believe the Non-Executives were individually and in aggregate well-qualified to oversee the Group's activities [...] It was [...] always unlikely to have the concentration of banking expertise among its Non-Executives as might for example be possible for a business concentrating entirely on banking.¹³⁷

He noted the engagement of non-executive directors with the business at board meetings and outside, and recollected that the Board had "lively debates":

I think our chairman was good at encouraging the board to focus on the substantive issues before them, so that we could, within an acceptable time frame of the meeting, have good discussions on the substantive issues.¹³⁸

88. Andy Hornby felt that "the HBOS Board always had very extensive banking experience". He observed that Anthony Hobson, Chairman of the Audit Committee "had very considerable relevant experience in the financial services industry, including having been Finance Director of Legal & General for approximately ten years".¹³⁹ Anthony Hobson himself stressed the diverse experience of board members and considered that the qualifications of the Board were "at least as good as those found on the Board of other UK financial institutions at the time".¹⁴⁰ Sir James Crosby felt that the Board had possessed adequate experience among its executives and non-executives to challenge the Group's

135 B Ev w 215

136 Qq 1371-1372

137 B Ev w 183 - 184

138 Q 1374

139 B Ev w 237

140 B Ev w 226

corporate banking activities.¹⁴¹ Andy Hornby never considered that the non-executive directors “felt restrained from challenging the executive team in whatever way was most appropriate”.¹⁴²

89. Lord Stevenson did not accept that the board he chaired failed in its challenge to the executive.¹⁴³ He said that much thought was given to ensuring that “there was a lot of challenge and different ways of challenging”.¹⁴⁴ There was

an atmosphere where people were able to be very direct and blunt. There were one or two occasions when great offence was caused, but we had a very open society. There was constant challenge, not just of corporate, but of the other divisions.¹⁴⁵

In conclusion, he told us:

I think the governance was rather good. That does not mean to say it was perfect. I am open to any suggestions how it could have been. The board meetings were functional and gave huge opportunity for challenge.¹⁴⁶

90. The positive self-assessment of the abilities of the HBOS Board was echoed by the views of the FSA. According to Clive Briault:

The risk assessments during the relevant period indicate that corporate governance was thought to be effective at HBOS. There was some banking experience among the non-executive directors and a considerable amount of wider corporate experience.¹⁴⁷

Conclusions

91. The corporate governance of HBOS at board level serves as a model for the future, but not in the way in which Lord Stevenson and other former Board members appear to see it. It represents a model of self-delusion, of the triumph of process over purpose.

92. Peter Hickman said that the expectation was that the Board would approve the executive business plans; challenge would be expected to come from the executives, rather than the non-executives or the full Board. He could not recall any significant change made by the Board, if any.¹⁴⁸ As with other boards, the Board of HBOS on occasions had an opportunity to assess its own performance. On 24 February 2004, the minutes record it being told the following:

The Board made effective but supportive challenges, as necessary, and would not seek to second guess executive management’s formulation of strategy.¹⁴⁹

141 Q 1378

142 B Ev w 235

143 Q 1625

144 Q 1627

145 Q 1625

146 Q 1627

147 B Ev w 180

148 BQq 503-504

149 B Ev w 371

The Board, in its own words, had abrogated and remitted to the executive management the formulation of strategy, a matter for which the Board should properly have been responsible.

93. The executive leadership represented on the Board came predominantly from a retail and insurance background. Sir James Crosby had an insurance background and Andy Hornby came to HBOS from the retailing industry. Its successive financial directors came from predominantly insurance or retail banking backgrounds. As Sir James Crosby conceded, this led to too much faith being placed in the senior executives with corporate banking experience, Colin Matthew and, in succession, George Mitchell and Peter Cummings.¹⁵⁰ Andy Hornby also agreed that, in retrospect, insufficient attention was paid at the highest level to corporate lending compared with retail exposures.¹⁵¹ **There was insufficient banking expertise among HBOS's top management. In consequence, they were incapable of even understanding the risks that some elements of the business were running, let alone managing them.**

94. **The non-executives on the Board lacked the experience or expertise to identify many of the core risks that the bank was running. In Sir James Crosby's revealing phrase, it was not composed in a manner that would be appropriate for "a business concentrating entirely on banking". The board was composed in a manner which appeared suitable for a retail-oriented financial services company, but that board lacked the necessary banking experience among its non-executives, particularly in relation to higher risk activities, for a bank whose strategy and business model was posited on asset-led growth led by non-retail divisions of the bank.**

95. **Judging by the comments of some former Board members, membership of the Board of HBOS appears to have been a positive experience for many participants. We are shocked and surprised that, even after the ship has run aground, so many of those who were on the bridge still seem so keen to congratulate themselves on their collective navigational skills.**

150 Q 1301

151 Q 1446

7 Downfall

The need for and provision of funding

96. From its formation HBOS had a large wholesale funding requirement, as both Halifax and BoS had been already significant users of wholesale funding even prior to the merger. At the Group's formation in 2001, the Group had a loans/deposits ratio of 143 per cent and a customer funding gap of £61 billion. The Retail Division, which had been substantially derived from Halifax, had customer loans of £137 billion and deposits of £97 billion—a customer funding gap of £40 billion.¹⁵² The rest of the HBOS Group, substantially derived from BoS, had a customer funding gap of £21 billion.¹⁵³

97. HBOS's growth strategy meant that the funding gap increased. Customer deposits grew at a slower rate than assets. Deposits rose at 8 per cent a year between 2001 and 2008, compared with asset growth of around 13 per cent.¹⁵⁴ By the end of 2008, the loans/deposits ratio had risen to 196 per cent and the customer funding gap had increased to £212.9 billion. The Retail Division's customer funding gap had risen to £112 billion, the Corporate Division had a gap of £78 billion, and the International Division a gap of £54 billion. All three of the Group's principal banking divisions contributed to the increase in the Group's overall customer funding gap and the greater need for wholesale funding over the period from 2001 to 2008.

98. The Treasury Division's first priority was sourcing the funding to support the Group's asset led strategy.¹⁵⁵ Management papers throughout the period show that the planned asset growth posed challenges for the Treasury Division in raising the funding to support it, even before the onset of the financial crisis. The 2003-07 Business Plan (drawn up in 2002) cited funding and liquidity as possibly the bank's "greatest single challenge".¹⁵⁶ The Finance Director explained to the Group Board in November 2002 that their five-year business plan would make HBOS "the largest wholesale funded clearing bank in the UK", and Sir James Crosby acknowledged that funding was a "significant risk".¹⁵⁷ On 1 March 2005, the Board was told:

Liquidity [...] remained a significant management challenge. HBOS was structurally illiquid: this needed to be overcome through ensuring sources of funds were appropriately diversified, with identified additional capacity in case of need.¹⁵⁸

Lindsay Mackay, Head of the Treasury Division, told the Executive Committee in 2006 that the bank's existing wholesale funding capacity would be reached in 2009 under their current Plan. HBOS had "the highest wholesale funding need of any of the UK banks (and

152 HBOS, *2002 Annual Report and Accounts: "Even in tough markets, this is the strategy that delivers"*, p 7

153 *Ibid.*, pp 70, 129

154 HBOS, *2001 Annual Report and Accounts: The New Force* and HBOS, *2008 Annual Report and Accounts*

155 HBOS, *2007 Annual Report and Accounts: Delivering our Strategy ...*, p 60

156 HBOS Plc, *Secret 20/20 Vision Group Business Plan 2003-2007*, p 61

157 B Ev w 348

158 B Ev w 402

was close to the other Big Four banks combined)". He informed the Executive Committee that, in the longer term, the position was "untenable and unsustainable".¹⁵⁹

99. HBOS took steps to mitigate its reliance on wholesale funding, including: increasing the efforts to source customer deposits; diversifying wholesale funding sources by nature, currency and type of investor;¹⁶⁰ holding a significant pool of liquid assets; and undertaking stress tests and scenario analyses.¹⁶¹ The Group also made efforts to diversify its sources of wholesale funding, through the issuance in different currencies of covered bonds, asset-backed securities and senior debt. It also sought to lengthen the maturity of its wholesale funding. The proportion of wholesale funding with a maturity of under one year was reduced from 86 per cent in 2001 to 50 per cent by 2008. However, the bank used the benefits of its measures to raise longer term wholesale funding to support asset growth, rather than to reduce short-term wholesale funding in absolute terms. At the end of 2008 HBOS had £238 billion of wholesale funding outstanding, of which £119 billion had a maturity of less than a year, compared with £90 billion in 2001.¹⁶²

100. The onset of the financial crisis in the second half of 2007 led to a shortening of the wholesale funding profile, as maturing longer term funding could only be replaced by shorter duration maturities.¹⁶³ In consequence, the proportion of HBOS's wholesale funding with a duration longer than one year fell from 47 per cent in mid-2007 to just over 40 per cent a year later.

101. Once the financial crisis began, HBOS did attempt to moderate its overall asset growth plans. However, several executives indicated in evidence that the reliance on the markets for wholesale funding made the Group cautious about the signals it was sending: being too aggressive in scaling back growth risked worrying the market that the bank might be in difficulty.¹⁶⁴ In September 2007, Philip Hodgkinson, Group Finance Director, outlined to the Executive Committee steps to reduce asset growth and increase liabilities, although full-year asset growth would still be above plan. However, he also indicated, lending "could not simply be 'turned off'".¹⁶⁵ Growth targets for 2008 were reduced by £10 billion, largely in the International Division, and the Group targeted increased liability growth.¹⁶⁶ However, as we noted earlier, asset growth in the Corporate Division was accelerating soon after these measures were agreed.

102. Successive Executive Committee and Board papers during the financial crisis indicate management took the funding position seriously. The day after the announcement that Northern Rock had been granted emergency Bank of England assistance, HBOS set up a Contingency Planning Group, and Andy Hornby indicated that planned business growth

159 B Ev w 319

160 The Group's wholesale funding included covered bonds, securitisations and senior debt. It also raised funds in different currencies. However, as the table above illustrates, US dollar funding proved to be relatively volatile over the crisis and the HBOS balances from this source approximately halved in 2008, as shown in HBOS, *2008 Annual Report and Accounts*, p 27.

161 BQq 54, 345, 437, 472, 529

162 HBOS, *2008 Annual Report and Accounts*, p 27

163 BQq 539 - 540

164 BQq 355, 496

165 B Ev w 326

166 B Ev w 330, 333 - 334

was no longer prudent.¹⁶⁷ On 18 September 2007, Lindsay Mackay discussed with the Executive Committee contingency planning designed to avoid HBOS becoming “the next Northern Rock”.¹⁶⁸ Initially at least, the management believed the external perception to be of a bank that had “managed its position through the liquidity crunch extremely well”.¹⁶⁹ It felt regarded as one of the larger Clearing Banks, distinct from the monoline or smaller mortgage banks.¹⁷⁰ Philip Hodkinson said that the responses to stressed conditions, which the Group had prepared and which took effect in late 2007, together with other measures, were working and the Group felt “in good shape”.¹⁷¹

103. On 13 November 2007, Lord Stevenson wrote to the Chairman of the FSA about how it was coping with the pressures of the financial crisis. He said:

[...] You asked how HBOS felt on the ‘ladder of vulnerability’. Answer: without wishing to be complacent or hubristic, management has done a superb job—a job that started five years ago and not in August; most recently Andy Hornby has led his top managers into making some very tough decisions to ration assets growth next year. Good always comes out of difficult times [...]

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 [...] not just over the last three months but the last five years --- to demonstrate its sense of responsibility and competence and that there could be some release of the FSA paranoia button!¹⁷²

104. As the crisis progressed, the HBOS credit default swap levels widened, both in absolute and relative terms.¹⁷³ The Group suffered an attack from short sellers in March 2008, which led to the withdrawal of some deposits that stabilised after an FSA statement. The market was also concerned with the structure of the HBOS balance sheet, notably its loans/deposits ratio and the absolute size of its wholesale funding.¹⁷⁴

105. On 17 March 2008, the day of the announcement of the acquisition of Bear Stearns by JP Morgan in a rescue involving the Federal Reserve, the Chairman of the FSA called Lord Stevenson to ask how he was feeling. Lord Stevenson’s response the next day was bullish:

I and we are feeling about as robust as it is possible to feel in a worrying environment which we would rather did not exist! As I said to you we have faced into the need to be **boringly boring** for the next year or two and we are setting out our stall to do that [...]

We have had no problems in financing ourselves over the past six months even on the hairiest of days and weeks [...]

167 B Ev w 322

168 B Ev w 326

169 B Ev w 422

170 B Ev w 325 - 326

171 BQ 440

172 B Ev w 530

173 B Ev w 427

174 BQ 472

My soberly considered view is that given the extraordinary external environment, **HBOS in an admittedly uncertain and worrying world is in as secure a position as it could be** [...]

How would we fare if liquidity completely dried up, you asked? Does that keep me awake at night? Well yes of course one worries about everything, but the answer is no! First, our close monitoring of those who supply the lines of credit leads us to the view that the circumstances in which ours would be withdrawn would either be the 'freak' circumstances outlined above (but even that is judged to be unlikely) or where the world has collapsed to the extent that all bets of all kinds would be off. The commonsense of the situation is that **we are dealing with lenders looking to lend money to a highly conservative institution** [...]

The bottom line is 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 while at the same time feeling commercially rather frustrated.¹⁷⁵

By September 2008, it became clear that, far from being "a highly conservative institution" in a safe harbour, HBOS was in a storm-tossed sea.

106. It was also holed below the water line. HBOS's £60 billion liquid assets pool proved ineffective, because the bank was unable to sell or raise funds against it in the crisis, due to the nature of its investments and the seizure of wholesale markets.¹⁷⁶ Indeed, the market's concerns about potential losses in HBOS's investment and liquidity portfolios actually contributed to the market's increasing concerns about the bank.¹⁷⁷ HBOS was forced to supply liquidity to the Grampian conduit, which was unable to finance itself on the wholesale markets at attractive rates.¹⁷⁸ The decision by Lehman Brothers to file for bankruptcy on 14 September 2008 also proved fatal to HBOS. HBOS suffered from a two-fold crisis. First, there was an outflow of around £30 to £35 billion of customer deposits.¹⁷⁹ The majority of this outflow was by non-bank financial and large corporate, rather than retail, customers.¹⁸⁰ Second, as some of the shorter term borrowing taken out the previous Autumn fell due, HBOS found itself faced with the closure of wholesale markets, except the overnight market. In this situation, HBOS was unable to raise sufficient wholesale market financing to meet its outflows.¹⁸¹

175 B Ev w 534; emphasis in original Ev w

176 BQ 440

177 BQ 472

178 HBOS, *2007 Annual Report and Accounts: Delivering our strategy ...*, p 97; and HBOS, *2008 Annual Report and Accounts*, p 28

179 BQ 533

180 HBOS, *2008 Annual Report and Accounts*, p 26

181 BQ 570

The endgame and its consequences

107. Faced with this situation, the Board soon concluded that it needed to “secure a more stable long-term solution” in the form of takeover by Lloyds TSB.¹⁸² The terms for the recommended acquisition were announced by Lloyds TSB on 18 September 2008. Pending completion of the takeover, which took place on 16 January 2009, HBOS was forced to accept Emergency Liquidity Assistance from the Bank of England on 1 October 2008.

108. Former HBOS shareholders have seen 96 per cent of its peak value disappear, and what remains is the result of support from the UK taxpayer and the acquisition by Lloyds TSB. The Treasury provided £20.5 billion to HBOS, Lloyds TSB and Lloyds Banking Group (LBG).¹⁸³ These injections by the Treasury were followed by subsequent injections by LBG into HBOS. Combined, the Treasury and LBG injected a total of £28 billion of equity into HBOS.¹⁸⁴ The market value of the Treasury holding in LBG is still £5 billion below the £20.5 billion invested.¹⁸⁵ In 2009 Eric Daniels maintained that LBG would not have needed state aid if it had not acquired HBOS.¹⁸⁶

109. There has also been an adverse effect on the operation of the banking market. HBOS was weakened in its ability to continue its retail lending and its support for SMEs. The banking market has become less diverse and less competitive in consequence of the merger. UK competition law was altered in October 2008 to include a new public interest consideration of “maintaining the stability of the UK financial system”. This consideration was used to support a decision not to refer the Lloyds HBOS merger to the Competition Commission.¹⁸⁷ **Consumers and the wider economy, as well as shareholders and taxpayers, have paid a heavy price for the blunders of the HBOS Board.**

The full picture

110. All HBOS witnesses accepted that management did not expect, still less make contingency planning for, the severity of the financial crisis, including the near closure of term wholesale money markets to banks for over a year.¹⁸⁸ All senior management accepted that their failure to plan for such a severe funding and liquidity crisis as occurred was an error and many of them apologised for it. However, in evidence to the Treasury Committee in 2009 and in evidence to this Commission, senior figures within HBOS have portrayed themselves as victims of forces beyond their control. According to Sir Ron Garrick:

We were probably optimistic rather than pessimistic, but even the pessimists never forecasted the extent to which the liquidity crisis would strike and the impact it

182 Treasury Committee, Seventh Report of Session 2008-09, *Banking Crisis: dealing with the failure of the UK banks*, HC 416, para 120

183 National Audit Office, *HM Treasury Resource Accounts 2011-12: The Comptroller and Auditor General's Report to the House of Commons*, July 2012, p 10

184 HBOS, *2008 Annual Report and Accounts*, p 140; HBOS, *2009 Annual Report and Accounts*, p 70; HBOS, *2010 Annual Report and Accounts*, p 68

185 Lloyds Banking Group, *2011 Annual Report and Accounts*, pp 290, 303

186 Treasury Committee, Seventh Report of Session 2008-09, *Banking Crisis: dealing with the failure of the UK banks*, HC 416

187 House of Commons Library, *The Lloyds-TSB and HBOS Merger: Competition issues*, December 2008, p 7

188 Qq 1288, 1464

would have [...] We were on the beach when the tsunami came in; we were not on high ground.¹⁸⁹

111. Sir James Crosby denied that the growth in his time as Chief Executive made what subsequently happened “inevitable”.¹⁹⁰ He said that wholesale funding was seen as a risk to the strategy, but not a risk to the bank.¹⁹¹ The events that subsequently unfolded were “not a foreseeable scenario”.¹⁹² Andy Hornby suggested that the scale of losses on the corporate loan book went back to “the unforeseen and unprecedented total closure of wholesale markets”.¹⁹³

112. Lord Stevenson argued that there was a single cause of the failure of the HBOS:

The problem was the first protracted closure of wholesale markets since, I believe, 1913 [...] Had wholesale markets continued not completely closed, I think that events would have been different, but it was the closure of wholesale markets that, effectively, did for us.¹⁹⁴

At the end of 2011, the HBOS Group tangible ordinary shareholders' funds were £23 billion. However, this was only after injections first from the Treasury and subsequently from LBG, totalling £28 billion in 2009 and 2010. It is therefore clear that without these injections, HBOS would have had, and still would currently have, significant negative net worth, let alone insufficient equity capital with which to continue to operate. When this was put to Lord Stevenson, he rejected outright the suggestion that the capital provisions resulted from anything other than the liquidity problems in the particular circumstances of the closure of wholesale markets.¹⁹⁵ He went on to say:

As a matter of fact, what brought the bank down were global wholesale markets the day after Lehman. That was it.¹⁹⁶

113. If HBOS's difficulties were solely the result of funding and liquidity problems, their lasting effects would have been much more limited, including for the taxpayer. The impairments on its bad lending continued well after then. The market's justified fears over the quality of HBOS's lending were as much a cause of the Group's liquidity problems as the subsequent impairments were the result of an evaporation of liquidity. Michael Foot pointed out that banks which caused the markets the biggest concerns about asset quality tended to have the greatest problems refinancing wholesale funding.¹⁹⁷ This point was also acknowledged by George Mitchell, who said:

189 BQ 923

190 Q 1276

191 Q 1285

192 Q 1288

193 Q 1443

194 Q 1585

195 Q 1592

196 Q 1636

197 BQ 1069, 1071

It was the rapid rate of loan growth—not just in corporate, but in HBOS as a whole, when others had pulled back—that spooked the market and caused the collapse in the first place.¹⁹⁸

114. The other major bank failure which took place in the UK in 2008, that of RBS, was in considerable measure precipitated by a decision taken by the RBS Board after the onset of the financial crisis, namely the disastrous decision to acquire ABN AMRO. This acquisition was part of the story of how RBS weakened its mainstream bank through the growth of its investment banking business. **As a home-grown banking failure in traditional banking, HBOS stands alone.**

115. **The problems of liquidity were the occasion for the failure of HBOS, not the cause. If HBOS's difficulties were solely the result of funding and liquidity problems, their lasting effects would have been much more limited, including for the taxpayer. LBG has now repaid all the Government backed funding raised during the financial crisis. Without solvency pressures, HBOS would not have needed equity support from the taxpayer.**

116. **The HBOS failure was fundamentally one of solvency. Subsequent results have shown that HBOS would have become insolvent without capital injections from the taxpayer and LBG. At the end of 2011, the HBOS Group tangible ordinary shareholders' funds were £23 billion. However, this was only after injections, first from the Treasury and subsequently from LBG, totalling £28 billion in 2009 and 2010. It is clear that without these injections, HBOS would have become insolvent.**

117. **The bank's solvency pressures reflect substantial operating losses. HBOS reported pre-tax losses each year in the period 2008-11; the aggregate pre-tax losses for this period totalled £30 billion. These losses were the result of very large asset impairments. Aggregate impairments for the same period were £50 billion, concentrated in customer loan impairments, which totalled £46 billion. Losses on this scale necessitated the recapitalisations.**

118. Table 3 compares the HBOS impairments with those of the other large UK based commercial banks.

Table 3

Peer Group Loan Impairment Comparison					
Banking Group	HBOS	Barclays	HSBC Bank	Lloyds (ex HBOS)	RBS
2008-2011 impairments	45,835	22,964	8,799	10,909	37,549
2008 loans	435,223	461,815	298,304	242,735	731,165
2008-11 Impairments/2008 Loans	10.5	5.0	2.9	4.5	5.1

Source: Company published data

119. **The total 2008-11 HBOS loan impairments were equivalent to 10.5 per cent of the end 2008 customer loan book. This percentage was more than twice as high as the next largest proportion of loans incurred by a leading UK domestic commercial banking group, RBS, which also required Government equity injections. The disproportionate**

scale of impairments at HBOS compared to the UK banking industry, even to RBS, indicates the appalling condition of HBOS's asset base.

120. **The poor quality of HBOS's assets becomes even more stark when account is taken of the fact that more than half of the bank's loan portfolio was in residential mortgages, where impairments were proportionately substantially lower than for other types of lending. The group figures therefore contain much higher impairments as a proportion of loans in the corporate lending portfolios, both in the UK and abroad.**

121. Several leading former HBOS executives suggested to the Commission, that the company's impairments were the result of the financial crisis and the seizure of wholesale funding markets, which particularly affected its customers. The Chairman and both former CEOs acknowledged that the impairments were "appalling",¹⁹⁹ and Sir James Crosby accepted that the HBOS impairments indicated "incompetent" lending. However, all three put the emphasis on the unprecedented closure of the wholesale markets.²⁰⁰ In contrast, former FSA Managing Director, Michael Foot gave an alternative interpretation, pointing out that the banks where the market had concerns about their asset quality were the ones which tended to have the greatest problems refinancing wholesale funding.²⁰¹

122. **The explanation by senior HBOS management given to the Commission for the scale of the Group's losses is entirely unconvincing. The impairments and losses incurred were substantially worse than for the peer group. Losses have been sustained over a period of at least four years, indicative of fundamentally poor asset quality, rather than the result of temporary liquidity pressures. The losses were also incurred in three divisions, rather than concentrated in one area, indicative of more general asset quality weaknesses.**

123. **Poor asset quality was the direct result of the company's strategy, which pursued asset growth in higher risk areas. This asset growth was compounded by a risky funding strategy. The combination of higher risk assets and risky funding represents a fundamentally flawed business model and a colossal failure of senior management and of the Board.**

124. **Their misjudgements were toxic for HBOS. The problems of solvency were a direct consequence of the strategy set by the Board and the failure of controls on the practices that were fostered by its commitment to an asset-led, high-risk approach to growth.**

125. **The Commission was very disappointed by the attempts of those who led HBOS into the abyss to acknowledge, even now, either the nature of the problems that eventually consumed the bank or the extent to which they flowed from their own decisions rather than unforeseeable events. No bank is likely to be immune from the effects of an economic downturn, but the scale of HBOS's credit losses was markedly worse than that of any of its major peers. In these circumstances, the apologies of those at the top of HBOS for the loss imposed upon the taxpayers and others ring hollow; an**

199 Qq 1289, 1438, 1587

200 Qq 1303, 1444, 1562

201 BQq 1069, 1071

apology is due for the incompetent and reckless Board strategy; merely apologising for having failed to plan for an unforeseeable event is not much of an apology.

126. Many of the principal causes of the HBOS failure and the weaknesses in its business model were known to financial markets. Public disclosures by the Group showed the pace of asset growth, key distinctive features of the Corporate Division's assets (including the exposures to commercial real estate, leveraged finance and equity and joint ventures), the pace of the International Division's growth and its concentration in commercial real estate, and the overall Group reliance on wholesale funding. Nevertheless, the financial markets as a whole, including shareholders, debtholders, analysts and rating agencies, also failed to discipline the company's growth until it was too late. When they did, the Group had become a serious threat to financial stability.

The price of failure

127. At its creation in 2001, HBOS had an initial market capitalisation of £30 billion.²⁰² At its peak in 2007, the market capitalisation had grown to over £40 billion, when its tangible book value was £18 billion.²⁰³ The HBOS annual compound total shareholder return was 6.9 per cent over the period of nearly six years from its formation to the end of June 2007, when the equity market was also near its peak. As we have already noted, 96 per cent of that value has disappeared. Those who retained their shareholdings have therefore paid a large monetary price for failure. These shareholders include Lord Stevenson, who told us that he invested a great deal of his own money in HBOS shares.²⁰⁴

128. Sir James Crosby did not fare so badly.²⁰⁵ As with other directors, as part of the long term incentives element of his remuneration package, he received shares in HBOS. After leaving the bank in July 2006, Sir James chose to sell two thirds of his holdings.²⁰⁶ He told us that his motive for selling his shares was "balancing my portfolio of assets".²⁰⁷ Because Sir James disposed of so many of his shares before financial markets crashed, he would have fared considerably better than those who continued to hold all their shares in HBOS until the bank failed. This raised the issue of whether the period for vesting deferred shares is long enough. Sir James Crosby was knighted, was appointed to the FSA Board and then became its Deputy Chairman, before resigning in 2009.

129. One person has paid a more direct monetary price. Peter Cummings, who was Head of the Corporate Division which was the largest single source of impairments on the HBOS balance sheet in the three years from 2008, was fined £500,000 by the FSA. The FSA's Final Notice to Peter Cummings of 12 September 2012 states that the fine was imposed on the grounds that Peter Cummings failed to exercise due skill, care and diligence in managing the business of the firm for which he was responsible (a breach of FSA Principle 6) and was knowingly concerned in a contravention by the Bank of Scotland of Principle 3 (a firm

202 HBOS, 2001 Annual Report and Accounts: *The New Force*

203 HBOS, 2007 Annual Report and Accounts: *Delivering our strategy...*, pp 154-55, 207

204 Q 1531

205 Q 1234

206 Q 1234

207 Q 1235

must take reasonable care to organise and control its affairs responsibly and effectively; with adequate risk management systems).²⁰⁸ The enforcement action against Peter Cummings cost the FSA approximately £5.4mn (just over 12 per cent of the FSA's total annual enforcement budget for 2012/13).²⁰⁹ We have seen that the management of the Corporate Division contained significant weaknesses, which help to explain the scale of the losses. Peter Cummings had significant autonomy in the running of the Division, but he was not operating in complete isolation. Peter Cummings told us that he was under pressure from the top of the bank to increase profit targets year on year²¹⁰ because, as he told us, "there was a point where the retail bank was not performing and not delivering on the expectation, and I was asked to step in".²¹¹ Whilst accepting that the targets were not imposed on him, Peter Cummings said that, "I certainly made it clear to my superiors at that point that I was not all that happy about it".²¹²

130. Evidence from Peter Cummings reflected his dismay at the process to which he was subject by the FSA Enforcement Division, as well as the apparent arbitrariness of the means by which the level of his fine was eventually arrived at. On the way in which he been singled out for censure, Peter Cummings told us:

It is unfair, and it also seems a bit sinister. We are not the only failed bank. There are at least four or five of them, and I find it curious that I was singled out. So someone, somewhere decided that that was the appropriate action to be taken, and it is the best part of four years later, and this is the first time that I have been asked that question. I think it is sinister and curious.²¹³

131. In relation to the Enforcement process, Peter Cummings found the approach to fining an individual to be oppressive, noting that he had no institutional framework to fall back on; no ability to call witnesses; and no ability to analyse documents.²¹⁴ Peter Cummings said that "anything I explained to them, or any representations I made to them, frankly they were not interested".

132. On the way in which the fine was imposed, Peter Cummings told us:

I found it, if I am being blunt, quite inept and very disappointing. In terms of the way the process was explained to me, that I would have the ability to put my side, and I believe that I did in the various representations, but very little was referred to therein. They issued what my one legal team concluded was an unlawful notice, reducing the original fine from £1 million to £800,000, and we issued them with a notice to say that it was unlawful because they had not explained how the fine was constructed. Within 24 hours²¹⁵ the investigative team got back involved and then a phone call to my solicitors and one meeting and approximately two phone calls later

208 Peter Cummings, FSA Final Notice, 12 September 2012, pp 1 - 2

209 Memorandum from the Financial Services Authority, 29 January 2013

210 BQ 1225

211 BQ 1228

212 BQ 1235

213 BQ 1218

214 BQ 1372

215 Note by witness: "I now recall that this was more than 24 hours, although the investigative team responded very quickly."

the fine was reduced from £800,000 to £500,000 if I do not take the matter to the judicial [tribunal]²¹⁶

133. On the question of whether the FSA had considered taking enforcement action against anyone else from HBOS, they informed us that the enforcement investigation had been conducted in the context of the large impairment losses in the HBOS Corporate book and that “the evidence gathered in the investigation demonstrated clearly that the most culpable senior manager for the Corporate Division’s failings was Peter Cummings”. The FSA told us that it had considered the prospects of successfully establishing personal culpability against other individuals to be very low.²¹⁷

134. The analysis that we have undertaken of the circumstances of the downfall of HBOS leave no doubt that that downfall cannot be laid solely at the feet of Peter Cummings. While his personal responsibility for some staggering losses should properly be recognised, significant and indeed disastrous losses were also incurred by other divisions, whose heads have not been held personally accountable in the same way. Losses were incurred across several divisions. The losses were caused by a flawed strategy, inappropriate culture and inadequate controls. These are matters for which successive Chief Executives and particularly the Chairman and the Board as a whole bear responsibility.

135. We asked Sir James Crosby whether he considered himself a fit and proper person to run a financial company. He replied that he had no plans to apply to be considered as such, and doubted whether he would be approved if he applied.²¹⁸ Andy Hornby appeared sufficiently chastened by his experience at HBOS as to imply that he will also not be seeking further employment in the banking sector. Lord Stevenson viewed the question as to whether he was a fit and proper person to run a financial institution as “rather academic” given his age and that he had no intention of working in financial services.²¹⁹ Notwithstanding these points, Lord Stevenson remained in a non-executive position entailing his presence on the FSA approved persons register until 2012, and in fact only formally relinquished his position a matter of days before giving evidence to the Commission.²²⁰ **In the view of this Commission, it is right and proper that the primary responsibility for the downfall of HBOS should rest with Sir James Crosby, architect of the strategy that set the course for disaster, with Andy Hornby, who proved unable or unwilling to change course, and Lord Stevenson, who presided over the bank’s board from its birth to its death. Lord Stevenson, in particular, has shown himself incapable of facing the realities of what placed the bank in jeopardy from that time until now. Apart from allowing their Approved Persons status at HBOS to lapse as their posts were wound up, the FSA appears to have taken no steps to establish whether they are fit and proper persons to hold Approved Persons status elsewhere in the UK financial sector. In cases of this importance the Commission believes that simply allowing Approved Persons status to lapse is insufficient. The Commission therefore considers**

216 BQ 1371

217 Memorandum from the Financial Services Authority, 18 January 2013

218 Qq 1428–1430

219 Q 1705

220 Companies House Electronically Filed Document TM01, Resignation Details for Lord Henry Dennis Stevenson, 04/12/2012

that the FSA should examine, as part of its forthcoming review of the failure of HBOS, whether these three individuals should be barred from undertaking any role in the financial sector.

136. The Commission considers it a matter for profound regret that the regulatory structures at the time of the last crisis and its aftermath have shown themselves incapable of producing fitting sanctions for those most responsible in a manner which might serve as a suitable deterrent for the next crisis. We will consider the changes in regulatory powers or approach that will be needed to rectify this in our final Report.

8 Conclusion: a manual for bad banking

137. The downfall of HBOS provides a cautionary tale. In many ways, the history of HBOS provides a manual of bad banking which should be read alongside accounts of previous bank failures for the future leaders of banks, and their future regulators, who think they know better or that next time it will be different. We will ourselves seek to draw further lessons from the case of HBOS as we frame recommendations for the future in our final Report.

138. One lesson relates to structural reforms. As Sir Charles Dunstone, non Executive Director of HBOS 2001-08, observed, if HBOS had survived as an independent entity in the form it took in 2008, it would almost all fall within the proposed ring-fence.²²¹ **HBOS had no culture of investment banking; if anything, its dominant culture was that of retail banking and retail financial services more widely, areas from which its senior management were largely drawn. Whatever may explain the problems of other banks, the downfall of HBOS was not the result of cultural contamination by investment banking. This was a traditional bank failure pure and simple. It was a case of a bank pursuing traditional banking activities and pursuing them badly. Structural reform of the banking industry does not diminish the need for appropriate management and supervision of traditional banking activities.**

139. **Another lesson is that prudential supervisors cannot rely on financial markets to do their work for them. In the case of HBOS, neither shareholders nor ratings agencies exerted the effective pressure that might have acted as a constraint upon the flawed strategy of the bank. By the time financial markets were sufficiently concerned to act as a discipline, financial stability was already threatened.**

140. HBOS throughout its short life failed adequately to recognise and act upon the principal risks to its business models, including asset quality and liquidity risks. It may be possible for banks with small market shares to outperform the averages and avoid losses the industry as a whole is incurring. However, when the market shares are as significant as at HBOS, notably in the more vulnerable areas, it is highly unlikely that exceptional single name credit selection can be sufficient protection against a whole industry downturn. In fact, such selection is likely to be illusory and provide false comfort. This lesson also applies to international expansion plans which target significant market share growth from strong local incumbent banks; history has shown that foreign banks frequently have weaker franchises and are exposed to higher risks in downturns, and in this respect HBOS was simply another example.

141. The FSA is currently conducting the review commissioned by the Treasury Committee on the failure of HBOS, which we expect to shed further light on both the regulatory failures of the FSA and on the failings of HBOS itself. **Through our work, we have identified some of the themes on which we expect the FSA to expand. In particular, we require the FSA study to shed further light on the following issues:**

- a) **The extent of losses in each division, which we have had to estimate;**

- b) **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;**
- c) **The reasons for the reliance placed on reports commissioned from third parties as to the adequacy of controls within HBOS;**
- d) **The reasons why the FSA closed the issue of the prudence of HBOS's corporate credit provisions;**
- e) **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;**
- f) **The extent to which regulatory decision-making at all levels was influenced by the protests of HBOS senior management, including claims about disadvantage to its competitive position;**
- g) **The nature and extent of FSA senior management involvement with HBOS;**
- h) **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 the future) should be prohibited from holding a position at any regulated entity in the financial sector;**
- i) **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.**

We expect the Treasury Committee to monitor how far and how effectively the FSA pursues these issues.

Conclusions and recommendations

The 'new force in banking'

1. The strategy set by the Board from the creation of the new Group sowed the seeds of its destruction. HBOS set a strategy for aggressive, asset-led growth across divisions over a sustained period. This involved accepting more risk across all divisions of the Group. Although many of the strengths of the two brands within HBOS largely persisted at branch level, the strategy created a new culture in the higher echelons of the bank. This culture was brash, underpinned by a belief that the growing market share was due to a special set of skills which HBOS possessed and which its competitors lacked. The effects of the culture were all the more corrosive when coupled with a lack of corporate self-knowledge at the top of the organisation, enabling the bank's leaders to persist in the belief, in some cases to this day, that HBOS was a conservative institution when in fact it was the very opposite. We consider the effects of these cultural weaknesses in the chapters that follow. (Paragraph 19)

The avenues to impairment

2. Although separate reporting for the former divisions of HBOS has ceased since it became part of Lloyds Banking Group, we estimate that aggregate customer loan impairments on Corporate Division loans in the period 2008 to 2011 totalled some £25 billion, equivalent to 20 per cent of the end 2008 loan book, not counting further impairments and write-downs on equity and joint venture investments. (Paragraph 28)
3. The growth of HBOS's Corporate Division was not the result of superior performance but of its high-risk strategy. The nature of its activities did not alter after the creation of HBOS, although the pace of growth accelerated and the scale significantly increased. When the Division later incurred huge losses, these too were due to the particular nature of its business and resulted directly from its high-risk strategy. Its losses were on a larger proportionate scale than those incurred by any other major UK bank. This was caused specifically by its distinctive loan book, including concentration in commercial real estate and leveraged loans, high exposure to single names, a high proportion of non-investment grade or unrated credit and holdings of equity and junior debt instruments. The loan book was therefore significantly more exposed to the domestic downturn than that of any other large UK corporate banking businesses. (Paragraph 30)
4. The acceleration in loan growth, in part caused by the Division's neglect of the storm signals of 2007 and 2008, is likely to have exacerbated the scale of the subsequent losses. However, even without this acceleration, the Division would still have incurred disastrous losses. The roots of all these mistakes can be traced to a culture of perilously high risk lending. The picture that emerges is of a corporate bank that found it hard to say 'no'. (Paragraph 31)

5. In view of the reckless lending policies pursued by HBOS Corporate Division, we are extremely disappointed by the attempts of the most senior leaders of HBOS at the time to attribute the scale of the consequent losses principally, or in significant measure, to the temporary closure of wholesale markets. The lending approach of the Corporate Division would have been bad lending in any market. The crisis in financial markets was merely the catalyst to expose it. Losses in the Corporate Division did not prove temporary. Indeed, we estimate that the HBOS Corporate loan book has continued to incur significant impairments in every year since 2008, demonstrating that the losses were the result of incompetent lending and not caused solely by the events of 2008. Furthermore, HBOS's Corporate Division was significantly more exposed than other banks to the downturn in the economy due to the nature of its loan book. (Paragraph 32)
6. Abroad as at home, HBOS took what it saw as the relatively quick and easy path to expansion without acknowledging the risks inherent in that strategy. As in the UK, HBOS concentrated on sectors which enhanced the intensity of its subsequent exposure. In two markets alone—Australia and Ireland—it incurred impairments of £14.5 billion in the period from 2008 to 2011. These losses were the result of a wildly ambitious growth strategy, which led in turn to significantly worse asset quality than many of its competitors in the same markets. The losses incurred by HBOS in Ireland and Australia are striking, not only in absolute terms, but also in comparison with other banks. The HBOS portfolio in Ireland and in Australia suffered out of proportion to the performance of other banks. The repeated reference in evidence to us by former senior executives to the problems of the Irish economy suggests almost wilful blindness to the weaknesses of the portfolio flowing from their own strategy. (Paragraph 39)
7. As the financial crisis hit, the HBOS Treasury Division turned from a source of profit to another source of loss. The aggregate profit and loss charges attributable to the Division in the period from 2008 to 2011 totalled £7.2 billion. Losses on this scale alone would have required recapitalisation of the Group. All relevant functions at HBOS, from the Board downwards, did not properly understand the nature of the risks embedded in the Treasury Division's structured investment portfolio, either from a credit risk or liquidity perspective. (Paragraph 42)
8. Far from providing liquidity and offering some protection against the Group's use of wholesale funding, the liquidity of the portfolio evaporated when the financial crisis developed, substantial losses were incurred as a result of a sharp decline in market valuations and the size and nature of the securities portfolio served to increase market concerns towards HBOS. The bank was, of course, far from unique in incurring losses in structured investments; many other banks, both in the UK and in other countries, also incurred such losses. However, HBOS was excessively confident that its understanding of UK residential mortgages and related securitisations gave it the ability to understand and evaluate the risks in a wide range of asset-backed investments. (Paragraph 43)
9. The impairments incurred by the Retail Division were substantially less than those incurred by the Corporate and International Divisions and were not a material factor in the failure of HBOS. The Retail Division is likely to have remained profitable

during the crisis period and subsequently, albeit at a reduced level. We note, however, that the Division incurred substantially higher mortgage-related losses than its major competitors, reflecting the bank's strategy of pursuing growth in higher risk non-standard mortgages. We also note that the Division's customer funding gap was a major factor in the Group's overall funding gap, which was a principal immediate cause in the short term of the failure of the bank. Prudent customer funding should have been a secure source of stability during market storms. (Paragraph 46)

10. The massive impairments in HBOS were not confined to a single division. In the case of the Corporate Division, the impairments of £25 billion on their own would have threatened the ability of the bank to operate or require complete recapitalisation. The impairments in the International Division of £15 billion set HBOS apart among its comparators and, although smaller than in the Corporate Division in absolute terms, were larger as a proportion of the loan book. They too would have been sufficient on their own to necessitate substantial recapitalisation. The losses in the Treasury Division of £7 billion would also have been sufficient on their own to require recapitalisation. Both the relative scale of such large losses and the fact that they were incurred in three separate divisions suggests a systemic management failure across the organisation. Taken together, the losses in these three divisions would have led to insolvency. (Paragraph 47)

A failure of internal control

11. The HBOS Group operated a federal model, with considerable independence given to the divisions. Central challenge to the divisions from senior executive management appears to have been inadequate in the case of the three divisions that ultimately caused the most significant losses (Corporate, International and Treasury). HBOS senior management derived from Halifax and the Retail Division. Accordingly, their understanding of retail banking was stronger, and their relative weakness in other areas meant that their reliance on divisional management in the corporate banking areas was greater. The key role of assessing exposure to future credit risks was dominated by the executives of the individual divisions. These weaknesses in senior management were instrumental in the pursuit by these three divisions of the policies and practices that led to devastating losses. (Paragraph 53)
12. Group senior management and central risk functions had greater understanding of the Retail business and several of them had direct expertise of working on the Retail side. There was therefore greater involvement by senior management and central functions in Retail and greater willingness to accept that on the part of the Division. By contrast, there was much more limited challenge and ability to challenge Corporate, International and Treasury activities and also, on the part of Corporate at least, willingness to accept it. (Paragraph 63)
13. The risk function in HBOS was a cardinal area of weakness in the bank. The status of the Group risk functions was low relative to the operating divisions. Successive Group Risk Directors were fatally weakened in carrying out their duties by their lack of expertise and experience in carrying out a risk function, by the fact that the centre of gravity lay with the divisions themselves rather than the group risk function, and by the knowledge that their hopes for career progression lay elsewhere in the bank.

The degradation of the risk function was an important factor in explaining why the high-risk activities of the Corporate, International and Treasury Divisions were not properly analysed or checked at the highest levels within the bank. (Paragraph 64)

14. The weaknesses of group risk in HBOS were a matter of design, not accident. Responsibility for this lies with Sir James Crosby, who as Chief Executive until 2005 was responsible for that design, with Andy Hornby, who failed to address the matter, and particularly with Lord Stevenson as Chairman throughout the period in question. (Paragraph 65)

A failure of regulation

15. The picture that emerges is that the FSA's regulation of HBOS was thoroughly inadequate. In the three years following the merger the FSA identified some of the issues that would eventually contribute to the Group's downfall, notably the risk that controls would fail to keep pace with aggressive growth and the Group's reliance on wholesale funding. The FSA failed to follow through on these concerns and was too easily satisfied that they had been resolved. The FSA took too much comfort from reports prepared by third parties whose interests were not aligned with those of the FSA. (Paragraph 83)
16. From 2004 until the latter part of 2007 the FSA was not so much the dog that did not bark as a dog barking up the wrong tree. The requirements of the Basel II framework not only weakened controls on capital adequacy by allowing banks to calculate their own risk-weightings, but they also distracted supervisors from concerns about liquidity and credit; they may also have contributed to the appalling supervisory neglect of asset quality. The FSA's attempts to raise concerns on these other fronts from late 2007 onwards proved to be a case of too little, too late. (Paragraph 84)
17. The experience of the regulation of HBOS demonstrates the fundamental weakness in the regulatory approach prior to the financial crisis and as that crisis unfolded. Too much supervision was undertaken at too low a level - without sufficient engagement of the senior leadership within the FSA. The regulatory approach encouraged a focus on box-ticking which detracted from consideration of the fundamental issues with the potential to bring the bank down. The FSA's approach also encouraged the Board of HBOS to believe that they could treat the regulator as a source of interference to be pushed back, rather than an independent source of guidance and, latterly, a necessary constraint upon the company's mistaken courses of action. (Paragraph 85)
18. Regulatory failings meant that a number of opportunities were missed to prevent HBOS from pursuing the path that led to its own downfall. The priorities of the supervisor also reinforced the senior management of HBOS in their own misplaced priorities. Ultimate responsibility for the bank's chosen path lies, however, not with the regulator but with the Board of HBOS itself. (Paragraph 86)

'The best board I ever sat on'

19. The corporate governance of HBOS at board level serves as a model for the future, but not in the way in which Lord Stevenson and other former Board members appear to see it. It represents a model of self-delusion, of the triumph of process over purpose. (Paragraph 91)
20. The Board, in its own words, had abrogated and remitted to the executive management the formulation of strategy, a matter for which the Board should properly have been responsible. (Paragraph 92)
21. There was insufficient banking expertise among HBOS's top management. In consequence, they were incapable of even understanding the risks that some elements of the business were running, let alone managing them. (Paragraph 93)
22. The non-executives on the Board lacked the experience or expertise to identify many of the core risks that the bank was running. In Sir James Crosby's revealing phrase, it was not composed in a manner that would be appropriate for "a business concentrating entirely on banking". The board was composed in a manner which appeared suitable for a retail-oriented financial services company, but that board lacked the necessary banking experience among its non-executives, particularly in relation to higher risk activities, for a bank whose strategy and business model was posited on asset-led growth led by non-retail divisions of the bank. (Paragraph 94)
23. Judging by the comments of some former Board members, membership of the Board of HBOS appears to have been a positive experience for many participants. We are shocked and surprised that, even after the ship has run aground, so many of those who were on the bridge still seem so keen to congratulate themselves on their collective navigational skills. (Paragraph 95)

Downfall

24. Consumers and the wider economy, as well as shareholders and taxpayers, have paid a heavy price for the blunders of the HBOS Board. (Paragraph 109)
25. As a home-grown banking failure in traditional banking, HBOS stands alone. (Paragraph 114)
26. The problems of liquidity were the occasion for the failure of HBOS, not the cause. If HBOS's difficulties were solely the result of funding and liquidity problems, their lasting effects would have been much more limited, including for the taxpayer. LBG has now repaid all the Government backed funding raised during the financial crisis. Without solvency pressures, HBOS would not have needed equity support from the taxpayer. (Paragraph 115)
27. The HBOS failure was fundamentally one of solvency. Subsequent results have shown that HBOS would have become insolvent without capital injections from the taxpayer and LBG. At the end of 2011, the HBOS Group tangible ordinary shareholders' funds were £23 billion. However, this was only after injections, first from the Treasury and subsequently from LBG, totalling £28 billion in 2009 and

2010. It is clear that without these injections, HBOS would have become insolvent. (Paragraph 116)

28. The bank's solvency pressures reflect substantial operating losses. HBOS reported pre-tax losses each year in the period 2008-11; the aggregate pre-tax losses for this period totalled £30 billion. These losses were the result of very large asset impairments. Aggregate impairments for the same period were £50 billion, concentrated in customer loan impairments, which totalled £46 billion. Losses on this scale necessitated the recapitalisations. (Paragraph 117)
29. The total 2008-11 HBOS loan impairments were equivalent to 10.5 per cent of the end 2008 customer loan book. This percentage was more than twice as high as the next largest proportion of loans incurred by a leading UK domestic commercial banking group, RBS, which also required Government equity injections. The disproportionate scale of impairments at HBOS compared to the UK banking industry, even to RBS, indicates the appalling condition of HBOS's asset base. (Paragraph 119)
30. The poor quality of HBOS's assets becomes even more stark when account is taken of the fact that more than half of the bank's loan portfolio was in residential mortgages, where impairments were proportionately substantially lower than for other types of lending. The group figures therefore contain much higher impairments as a proportion of loans in the corporate lending portfolios, both in the UK and abroad. (Paragraph 120)
31. The explanation by senior HBOS management given to the Commission for the scale of the Group's losses is entirely unconvincing. The impairments and losses incurred were substantially worse than for the peer group. Losses have been sustained over a period of at least four years, indicative of fundamentally poor asset quality, rather than the result of temporary liquidity pressures. The losses were also incurred in three divisions, rather than concentrated in one area, indicative of more general asset quality weaknesses. (Paragraph 122)
32. Poor asset quality was the direct result of the company's strategy, which pursued asset growth in higher risk areas. This asset growth was compounded by a risky funding strategy. The combination of higher risk assets and risky funding represents a fundamentally flawed business model and a colossal failure of senior management and of the Board. (Paragraph 123)
33. Their misjudgements were toxic for HBOS. The problems of solvency were a direct consequence of the strategy set by the Board and the failure of controls on the practices that were fostered by its commitment to an asset-led, high-risk approach to growth. (Paragraph 124)
34. The Commission was very disappointed by the attempts of those who led HBOS into the abyss to acknowledge, even now, either the nature of the problems that eventually consumed the bank or the extent to which they flowed from their own decisions rather than unforeseeable events. No bank is likely to be immune from the effects of an economic downturn, but the scale of HBOS's credit losses was markedly worse than that of any of its major peers. In these circumstances, the apologies of

those at the top of HBOS for the loss imposed upon the taxpayers and others ring hollow; an apology is due for the incompetent and reckless Board strategy; merely apologising for having failed to plan for an unforeseeable event is not much of an apology. (Paragraph 125)

35. Many of the principal causes of the HBOS failure and the weaknesses in its business model were known to financial markets. Public disclosures by the Group showed the pace of asset growth, key distinctive features of the Corporate Division's assets (including the exposures to commercial real estate, leveraged finance and equity and joint ventures), the pace of the International Division's growth and its concentration in commercial real estate, and the overall Group reliance on wholesale funding. Nevertheless, the financial markets as a whole, including shareholders, debt-holders, analysts and rating agencies, also failed to discipline the company's growth until it was too late. When they did, the Group had become a serious threat to financial stability. (Paragraph 126)
36. The analysis that we have undertaken of the circumstances of the downfall of HBOS leave no doubt that that downfall cannot be laid solely at the feet of Peter Cummings. While his personal responsibility for some staggering losses should properly be recognised, significant and indeed disastrous losses were also incurred by other divisions, whose heads have not been held personally accountable in the same way. Losses were incurred across several divisions. The losses were caused by a flawed strategy, inappropriate culture and inadequate controls. These are matters for which successive Chief Executives and particularly the Chairman and the Board as a whole bear responsibility. (Paragraph 134)
37. In the view of this Commission, it is right and proper that the primary responsibility for the downfall of HBOS should rest with Sir James Crosby, architect of the strategy that set the course for disaster, with Andy Hornby, who proved unable or unwilling to change course, and Lord Stevenson, who presided over the bank's board from its birth to its death. Lord Stevenson, in particular, has shown himself incapable of facing the realities of what placed the bank in jeopardy from that time until now. Apart from allowing their Approved Persons status at HBOS to lapse as their posts were wound up, the FSA appears to have taken no steps to establish whether they are fit and proper persons to hold Approved Persons status elsewhere in the UK financial sector. In cases of this importance the Commission believes that simply allowing Approved Persons status to lapse is insufficient. The Commission therefore considers that the FSA should examine, as part of its forthcoming review of the failure of HBOS, whether these three individuals should be barred from undertaking any role in the financial sector. (Paragraph 135)
38. The Commission considers it a matter for profound regret that the regulatory structures at the time of the last crisis and its aftermath have shown themselves incapable of producing fitting sanctions for those most responsible in a manner which might serve as a suitable deterrent for the next crisis. We will consider the changes in regulatory powers or approach that will be needed to rectify this in our final Report. (Paragraph 136)

Conclusion: a manual for bad banking

39. HBOS had no culture of investment banking; if anything, its dominant culture was that of retail banking and retail financial services more widely, areas from which its senior management were largely drawn. Whatever may explain the problems of other banks, the downfall of HBOS was not the result of cultural contamination by investment banking. This was a traditional bank failure pure and simple. It was a case of a bank pursuing traditional banking activities and pursuing them badly. Structural reform of the banking industry does not diminish the need for appropriate management and supervision of traditional banking activities. (Paragraph 138)
40. Another lesson is that prudential supervisors cannot rely on financial markets to do their work for them. In the case of HBOS, neither shareholders nor ratings agencies exerted the effective pressure that might have acted as a constraint upon the flawed strategy of the bank. By the time financial markets were sufficiently concerned to act as a discipline, financial stability was already threatened. (Paragraph 139)
41. Through our work, we have identified some of the themes on which we expect the FSA to expand. In particular, we require the FSA study to shed further light on the following issues:
- a) The extent of losses in each division, which we have had to estimate;
 - b) 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;
 - c) The reasons for the reliance placed on reports commissioned from third parties as to the adequacy of controls within HBOS;
 - d) The reasons why the FSA closed the issue of the prudence of HBOS's corporate credit provisions;
 - e) 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;
 - f) The extent to which regulatory decision-making at all levels was influenced by the protests of HBOS senior management, including claims about disadvantage to its competitive position;
 - g) The nature and extent of FSA senior management involvement with HBOS;
 - h) 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 the future) should be prohibited from holding a position at any regulated entity in the financial sector;
 - i) 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.

We expect the Treasury Committee to monitor how far and how effectively the FSA pursues these issues. (Paragraph 141)

Annex 1: The Corporate Division

Introduction

1. HBOS initially maintained separate divisions for Business Banking, which served small and medium-sized enterprise (SME) customers, and Corporate Banking, which serviced the larger corporate sector. In 2004 the bank merged these two divisions to form an enlarged Corporate Division. Our analysis of Corporate activities refers to the combination of Business Banking and Corporate Banking, as if the two divisions had been one throughout the period. The bulk of the foreign businesses were separated into a newly formed International Division in 2004. Our analysis of losses in this annex essentially refers to the domestic activities; we review the International businesses in the next annex.

Overview of the Corporate Division's business

2. The Corporate Division sustained strong loan growth from 2001 to 2008:

(£bn)	2001	2002	2003	2003 (Ex Intl)	2004	2004 PF	2005	2006	2006 (Restated)	2007	2008	CAGR
Customer Loans	55.1	69.5	81.4	72.2	78.8	73.2	79.2	85.3	90.3	110.9	123.0	14.4
Of which Property and Construction	13.3	19.7	26.1	23.8	26.8	26.4	28.5	29.9	30.7	41.0	44.3	20.1
Of which Hotels, Restaurants and Wholesale and Retail Trade	5.7	8.6	8.4	6.5	7.1	8.1	8.7	8.5	9.9	12.2	12.3	11.1
Deposits	22.2	26.4	37.4	31.2	38.6	39.0	41.7	38.7	39.5	44.1	38.5	10.5
Impairments (£m)	323	442	471	443	518	426	473	493	498	639	7,406	
Profits (£m)	823	988	1,230	1,101	1,376	1,171	1,420	1,663	1,776	2,320	-6,793	

Source: HBOS Report & Accounts and 2008 full year results press release.

Note: 2003 figures restated to exclude International activities; 2004, 2006 restated for accounting and group reorganisation. Growth rates adjust for these changes.

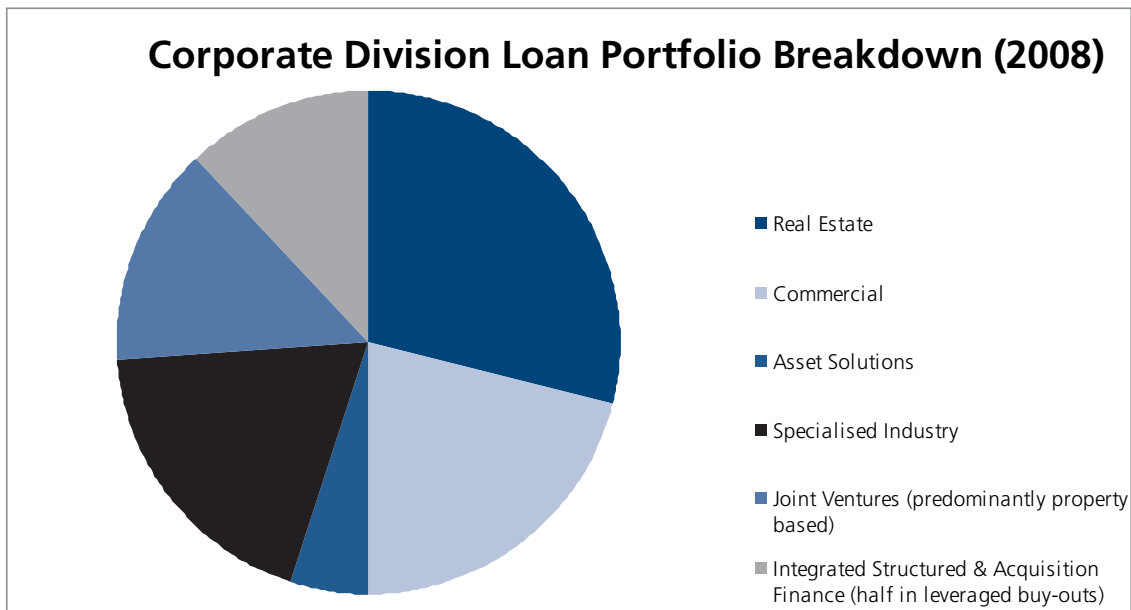
Loan growth averaged 14 per cent a year on an underlying basis, adjusted for intra-group transfers, which represents relatively strong real growth. Loan growth was stronger in the initial period following the merger, at 26 per cent in 2002 and 17 per cent in 2003, and slowed to 9 per cent in 2004 and 8 per cent in 2005 and again in 2006. Loan growth then accelerated to 22 per cent in 2007 and 12 per cent in 2008, at the top of the economic cycle. This growth, and the consequent increased pressure it put on the bank's funding position, was based on substantial risks. In the words of the FSA's final notice, the Corporate Division was "the highest risk part of HBOS's business".²²²

3. Asset growth was significantly ahead of customer deposits, which averaged 11 per cent on an underlying basis over the period. Consequently, the gap between customer loans and deposits increased from £33 billion at the end of 2001 to £84.5 billion by 2008. The Division's asset growth was therefore responsible for approximately £50 billion of the £150 billion net increase in the customer funding gap at the group level between 2001 and 2008.

Exposure to property and construction

4. The HBOS Corporate loan book contained a high and growing concentration in property. As can be seen from the above table, lending for property and construction represented a significant proportion – 36 per cent – of the Division's customer loans at the end of 2008. Lending for hotels, restaurants and wholesale and retail trade, which would also be significantly property based, represented a further 10 per cent. Lending to these two categories grew significantly faster than for the Division as a whole and represented 59 per cent of the net increase in the Corporate Division's loan outstandings over the 2001-08

period. The following chart shows a breakdown of the Division's loan portfolio at the end of 2008.



The FSA highlighted this “high degree of exposure to property”, totalling £68 billion or 56 per cent of the loan book at the end of 2008, in its final notice.²²³ The Division believed it had competitive advantage in commercial real estate (CRE). In a strategic review of the Division in 2007, Peter Cummings, CEO of the Division from 2005 to 2008, said that one of his five aspirations for the next five years was for HBOS to “be the best real estate bank in the UK.”²²⁴

Exposure to equity and exposure to leveraged finance

5. The Corporate Division formerly at BoS and then subsequently within HBOS had a very distinctive approach. The first HBOS Annual Report in 2001 proclaimed that the Division was “involved in a wide range of specialist activities.”²²⁵ In addition to the focus on property, the Division also engaged in equity finance and joint venture participations with customers. At the peak in 2008, HBOS had a portfolio of equity investments of at least £4.9 billion.²²⁶ There was a considerable degree of overlap in these activities, including loans to joint venture partners, an activity that was predominantly property based and a leveraged buy-out portfolio. The bank claimed in its 2001 Annual Report that it had been the “UK market leader” in management buyouts “by number of deals for the last 10 years” and was “also the market leader in Continental Europe.” Its activities in management buyouts were complemented by “close links with the venture capital industry with investment in 81 funds”. Integrated finance offered customers “a complete funding package” which includes

²²³ Bank of Scotland, FSA Final Notice, 9 March 2012, para 4.11 (1) and 4.12 (1)

²²⁴ B Ev w 307

²²⁵ HBOS, *2001 Annual Report and Accounts: The New Force*, p 28

²²⁶ “HBOS plc Interim Results 2008”, HBOS plc press release, 31 July 2008, p 21

“mezzanine debt and equity” in addition to “more traditional” lending.²²⁷ Some 10 per cent of the portfolio was in leveraged loans.²²⁸

6. The FSA final notice highlighted this “substantial exposure to equity and subordinated tranches of debt below mezzanine”, and the Division’s “substantial exposure to large highly leveraged transactions and the leveraged finance market”.²²⁹

Large individual credit exposures

7. The Division’s high risk profile included significant single name concentration, with the top 30 exposures in aggregate totalling £34.1 billion, 23 per cent of the portfolio and representing individual average exposure of £1.1 billion.²³⁰ The Division’s exposure to large single name borrowers increased over time as it took on increasingly large individual credit exposures. In September 2002, the largest single name approval was for £963,000. In September 2005, the largest single name approval was for £2.2 billion, and there were six names over £1 billion. In September 2008, the largest single name approval was £2.9 billion and there were nine names in excess of £1 billion.²³¹

The Corporate Division’s approach to credit assessment

8. BoS Corporate Banking had a tradition of lending into a downturn, or lending through the cycle. Indeed, the Division prided itself on this strategy and considered that it had served it well in “numerous cycles”.²³² The bank described itself as “never a fair-weather friend” and was proud that it supported customers “in bad times as well as good.”²³³ George Mitchell, CEO of HBOS Corporate Banking from 2001 to 2005, claimed the bank did not do such lending “blindly” but rather “on a case-by-case basis”, but he was also clear that this strategy something other banks were not doing and so was a source of competitive advantage to HBOS.

9. The Corporate Division had a strong sense of its ability to originate superior quality lending based on its track record, and this perception was shared by others across the Group. For instance, Peter Hickman, HBOS Group Risk Director 2007-08, highlighted the experience in the Corporate Division and their ability to do adopt a particular lending strategy “based on that experience”.²³⁴ The credit focus of the Division emphasized single name risk and much less portfolio construction, which was seen as the responsibility of group functions. Under HBOS’s system of credit approval, the so-called ‘first line of defence’ rested with the originating division. George Mitchell suggested that the first line of defence should be the “most robust” and that the “single credit protection was very much within the first line of defence,” even though this would have included “independent credit challenge to credits happening within the Division.”²³⁵ He considered the first line of

227 HBOS, 2001 Annual Report and Accounts: *The New Force*, p 28

228 BQ 409

229 Bank of Scotland, FSA Final Notice, 9 March 2012, para 4.11 (2) and (3)

230 Bank of Scotland, FSA Final Notice, 9 March 2012, para 4.12 (2)

231 B Ev w 437 - 448

232 BQ 630

233 HBOS, 2001 Annual Report and Accounts: *The New Force*, p 28

234 BQ 489

235 BQ 702

defence within the Corporate Division to have been “extremely robust”.²³⁶ By contrast, he regarded group functions as having responsibility for “macro issues like sector limits.”

10. However, the FSA Final Notice found that the Corporate Division had a culture of optimism, incentivised revenue focus rather than risk and viewed risk management as a constraint on the business rather than essential to it.²³⁷ Sir James Crosby accepted that too much confidence was placed in the Corporate Division’s management, given it was an “experienced team with a terrific track record.”²³⁸ He added that subsequent events showed the “risks that the corporate bank was taking were not as well understood as everybody thought” – a euphemism for poor lending.²³⁹ He accepted that incompetent lending in the Corporate Division ultimately brought the bank down.²⁴⁰

11. There were strong similarities between the approach followed by the HBOS Corporate Division and the strategy it had pursued previously within BoS. As we noted above, the 2001 HBOS Report & Accounts refer to several areas of existing strength in the Division, which remained distinctive features of the business within HBOS. Property and Construction already represented 24 per cent of the Division’s customer loans in 2001, with a further 10 per cent in Hotels, Restaurants and Wholesale and Retail Trade. George Mitchell confirmed that the type of lending HBOS’s Corporate Division engaged in was “no different” from the type of business the Division carried out when it was in Bank of Scotland.²⁴¹ He added that the kind of lending described in the FSA Final Notice was “absolutely”²⁴² the kind of lending that BoS had been doing. Peter Cummings expressed a similar view:

The two main focuses, I suppose, are private equity and real estate. The Bank of Scotland were a buy-out bank, and had been a buy-out bank since the 1980s when management buy-outs started to be developed as a discipline, and we were always a real estate bank.²⁴³

After the 2001 merger

12. The principal difference in the Corporate activity after the creation of HBOS was one of scale, as described in the 2001 HBOS Annual Report:

the bigger and stronger balance sheet that the merger has created will undoubtedly allow us to lead and arrange more transactions and underwrite and hold larger positions than either Bank of Scotland or Halifax could have done on their own. We have already seen clear evidence of this in the months since the merger and we

236 BQ 680

237 Bank of Scotland, FSA Final Notice, 9 March 2012, para 4.21

238 Q 1301

239 Q 1303

240 Q 1369

241 BQ 610

242 BQ 718

243 BQ 1170

remain confident that we can continue the strong growth we have experienced in recent years as well as delivering significant revenue synergies.²⁴⁴

13. After the merger, the Corporate Division's loan book grew by 26 per cent in 2002, 17 per cent in 2003, 9 per cent in 2004 and 8 per cent in 2005, illustrating the increased loan volumes the Division was able to originate and retain following the merger. George Mitchell described the shift as follows:

The big difference was after the merger. We had the size so that we could go into the underwriting market rather than just being a participant bank.²⁴⁵

14. HBOS also attempted to use the BoS product and the Halifax branch network to increase market share in SMEs, particularly in England. The 2001 Annual Report & Accounts set out an ambition to "break the mould" and mount a "strong challenge to the four clearing banks."²⁴⁶ The corporate bank planned to recruit 1,500 new staff over three years. Their strategy was to move from a transactional model (often property related), towards a relationship one, with distribution through 500 locations in England and Wales. The bank planned to make "significant inroads into the market"²⁴⁷ although the "Big Four had entrenched, valuable, positions."²⁴⁸ Peter Cummings admitted to the Commission that this was "a strategy that failed."²⁴⁹

Why did the Corporate Division increase its rate of lending from 2007?

15. The Corporate Division loan growth accelerated once the financial crisis began. Customer loan growth of 8 per cent a year in both 2005 and 2006 increased to 22 per cent in 2007 and 12 per cent in 2008, before impairments. The Commission received somewhat conflicting explanations for this acceleration. George Mitchell said that he was surprised by the pace of loan growth after he left the bank.

I was slowing growth every year. The year I left-2005-it had been 8 per cent. The plan was that it would be even lower the following year. That was because at the time I left there were clear signs that the credit markets were overheating and it was becoming increasingly difficult to source transactions with the right risk/reward characteristics.²⁵⁰

He suggested that HBOS's growth in 2007 and 2008 was not involuntary:

What surprised me, and is the one thing that has surprised me since I left HBOS, was when I read the annual report for '07 about the speed at which the bank— not just corporate—was growing, at a stage in the cycle when other banks were slowing or pulling back. That is a significant difference, because if I had still been in corporate, I

244 HBOS, *2001 Annual Report and Accounts: The New Force*, p 28

245 BQ 610

246 HBOS, *2001 Annual Report and Accounts: The New Force*, p 24

247 B Ev w 379

248 *Ibid.*

249 BQ 1168

250 BQ 698

find it difficult to believe that I would have been growing the business at that speed.²⁵¹

16. The HBOS report and accounts attributed Corporate loan growth to “strong originations and lower levels of refinancing and sell-down activity”²⁵² in the second half of 2007 and in 2008 “due to a pipeline of business.”²⁵³ Peter Cummings said that the acceleration in loan growth after August 2007 reflected increased “utilisation of facilities”,²⁵⁴ and “carrying on while nothing is getting sold,”²⁵⁵ also effectively attributing the rise in lending to the seizure of markets and the consequent inability to reduce exposures. These explanations suggest that some involuntary increase in lending is inevitable whenever secondary liquidity reduces. Peter Hickman, HBOS Group Risk Director from September 2007, agreed that during the crisis it was easier to slow lending in Retail than in Corporate.²⁵⁶ He agreed that slowing Corporate was like turning an oil tanker.²⁵⁷ However, Peter Hickman, also said that the bank made judgements “about maintaining a franchise and about the risk of being seen to be pulling back too hard.”²⁵⁸ He explained that HBOS was “more nervous” about the signals that it sent out than “a stronger bank” would have been.²⁵⁹ However, Peter Hickman also indicated slowing Corporate loan growth took some three months longer than other divisions, due to the greater difficulties in doing so and a greater reluctance on the part of the Division.²⁶⁰ Andy Hornby accepted that HBOS “should have slowed corporate quicker.”²⁶¹

17. Early in the financial crisis, Peter Cummings continued to make relatively confident comments. For example, in October 2007, he said: “Some people look as if they are losing their nerve, beginning to panic even in today’s testing property environment; not us.”²⁶² The Corporate section expected “only a modest increase in impairment losses in 2008”²⁶³ and claimed that the HBOS commercial property portfolio was “expected to continue to perform relatively well.”²⁶⁴ Peter Cummings claimed that whilst his public stance was to maintain confidence in the business, his actions were more cautious: “saying things and doing things are quite different.”²⁶⁵ He denied that the accelerated loan growth was a reflection of the policy BoS had successfully pursued previously of lending through downturns. He also denied that there was a culture of optimism at HBOS, or that he saw the onset of the financial crisis as an opportunity to gain share, without the need to change

251 BQ 698

252 HBOS, *2007 Annual Report and Accounts: Delivering our strategy...*, p 28

253 HBOS, *2008 Annual Report and Accounts*, p 8

254 BQ 1212

255 BQ 1206

256 BQ 510

257 *Ibid.*

258 BQ 495

259 BQ 496

260 BQ 509

261 Q 1461

262 BQ 1191

263 HBOS, *2007 Annual Report and Accounts: Delivering our strategy...*, p 32

264 *Ibid.*

265 BQ 1247

course.²⁶⁶ Instead, the Group was subject to “world events” that it “could not control.”²⁶⁷ However, he accepted that the Division was still writing new business in the 2007-08 period, “but only for existing customers”²⁶⁸ and “not very much”,²⁶⁹ although he was unable to say how much.²⁷⁰

18. The Group as a whole did take action to rein in growth, although Peter Hickman suggested that the Corporate Division showed a greater reluctance to slow loan growth than the other divisions and took some three months longer to do so.²⁷¹ The Executive Committee decided in October 2007 to “deliver a reduction in asset growth of £10 billion across the Group [in 2008].” However, it gave responsibility for delivering this reduction to the International businesses, rather than the Corporate Division.²⁷²

19. Several factors are likely to have been involved in the increase in the HBOS Corporate loan book in the early stages of the financial crisis. The seizure of wholesale markets and increased utilisation of facilities by customers are both likely to have been important factors. Furthermore, HBOS’s management did not react quickly enough to the crisis in its Corporate Division. The Division’s history and culture of lending through the cycle may also have played a role. However, it is not possible to quantify how much of the accelerated loan growth in 2007 and 2008 was involuntary and how much could have been avoided. Loans that were granted in 2007 and 2008 are likely to have been higher risk and disproportionately responsible for the level of subsequent impairments. Nevertheless, it is unlikely that more aggressive management action once the crisis began would have been enough to alter the fate of the Group. By that stage it was already too late.

The Division’s losses

20. The 2008 results revealed total impairments of £7.4 billion in the Corporate Division. HBOS ceased disclosing divisional breakdowns of its results after 2008, so the exact level of impairments incurred by the Corporate Division is not available. However, it is possible to estimate them by using the Group impairment figures and estimates for the charges at other divisions. We estimate that aggregate 2008-11 customer loan impairments on Corporate Division loans have totalled some £25 billion, equivalent to 20 per cent of the end 2008 loan book, not counting further impairments and write-downs on equity and joint venture investments.

21. The Corporate Division had a lower quality loan book. As the FSA pointed out, “the credit quality of the portfolio was low”, with “around 75 per cent” sub investment grade and a proportion “not rated at all”.²⁷³ George Mitchell attributed this low credit quality to the nature of the Division’s business, saying that “by definition” it was “sub-investment grade”.²⁷⁴ However, as the FSA pointed out in their final notice, the Corporate Division had

266 BQ 1250

267 BQ 1251

268 BQ 1315

269 BQ 1314

270 *Ibid.*

271 BQ 509

272 B Ev w 334

273 Bank of Scotland, FSA Final Notice, 9 March 2012, paras 4.11 (4) and 4.15

274 BQ 716

“a specific focus” on sub-investment grade lending, and HBOS’s corporate “book had a higher risk profile than the equivalent books at the other major UK banking groups.”²⁷⁵ The FSA concluded that the combination of factors to which we have drawn attention meant that the Division’s “portfolio was highly vulnerable to a downturn in the economic cycle”.²⁷⁶

22. Senior HBOS executives attempted to argue that the level of impairments reflected the impact of the financial crisis on the assets to which HBOS was exposed, rather than to inherently poor lending. They accepted that the level of impairments was “horrendous”,²⁷⁷ “horrible”²⁷⁸ and “appalling”.²⁷⁹ However, they attributed the impairments to the impact of the changed conditions after the financial crisis on the loan book, rather than on the nature of the loan book itself, although Peter Cummings acknowledged the role played by the concentration “in real estate” and the existence of “a private equity group”.²⁸⁰

23. George Mitchell argued that when he left in 2005 the corporate loan book was in “very good shape”:

I am not saying that in a deep recession impairments would not have risen and perhaps risen significantly; I think I am suggesting that these provisions would have been at a very manageable level.²⁸¹

He claimed that he would be “absolutely amazed if any major or significant losses came out of the book” he had left at the end of 2005.²⁸² He cited the FSA final notice as indicating that the “corporate book was turning over at 30 per cent per annum,”²⁸³ therefore implying that the individual customer identities would have substantially changed by 2008, when impairments deteriorated.

24. The Corporate Division’s growth was not the result of superior performance, but a consequence of its strategy. When the Division later incurred large losses, these too were due to the particular nature of its business and resulted directly from its strategy. Its losses were significantly higher than those incurred by any other major UK bank because of its distinctive loan book, which included high CRE and leveraged loan concentration, high exposure to single names, a high proportion of non-investment grade or unrated credit and holdings of equity and junior debt instruments. The nature of the loan book resulted in the Division being significantly more exposed to the domestic downturn than other large UK corporate banking businesses.

275 Bank of Scotland, FSA Final Notice, 9 March 2012, para 4.10. Elsewhere in the Report we examine the extent to which the division’s high risk business and lending strategy was matched by a commensurately robust level of control.

276 Bank of Scotland, FSA Final Notice, 9 March 2012, para 2.5

277 BQ 1213

278 Q 1558

279 Q 1438

280 BQ 1215-16

281 BQq 608-09

282 BQ 660

283 BQ 608

25. Former HBOS executives claimed that the bank's high impairments were due to the effects of financial markets on the Group's loan book and were not indicative of bad lending. We estimate that the HBOS Corporate loan book has continued to incur significant impairments in every year since 2008, implying that the losses are not related to temporary liquidity events in wholesale markets. HBOS's Corporate Division was significantly more vulnerable to the downturn in the economy due to the nature of its loan book.

26. The Corporate Division would have incurred substantial problems whenever the recession occurred. The nature of its lending did not alter due to the creation of HBOS, or subsequently. The losses would have been magnified by the Division's compound growth. However, significant losses as a proportion of loans would still have been incurred if the recession had struck earlier. George Mitchell's arguments to the contrary were not credible. Indeed, his confidence in the asset quality of the Division when he left is symptomatic of the Division's misplaced belief in its ability to source superior quality loans in higher risk segments. Although the book would have turned over significantly after he left the Group, all witnesses, including George Mitchell himself, agreed that the nature of the HBOS lending did not alter. In terms of growth, the 2006 business plan for the Corporate Division agreed by George Mitchell at the end of 2005 assumed 6 per cent asset growth for the Division.²⁸⁴ This compares with the 8 per cent actually generated.²⁸⁵ As losses are estimated to have ultimately reached 20 per cent of the loan book, it is difficult to regard the 2 per cent higher loan growth in 2006 as a material factor. The acceleration in loan growth in 2007 and 2008 at the peak of the economy is likely to have been a significant factor in the subsequent losses. However, simply slowing loan growth to even a low single digit rate would have been insufficient to avoid impairments on a scale that HBOS would have been unable to absorb on its own.

284 HBOS, *Group Business Plan 2006 – 2010, "Targeted Growth"*, p28

285 HBOS, *2006 Annual Report and Accounts: Our strategy has five key elements to create value*, p 42

Annex 2: The International Division

Introduction

1. The International Division was formed in 2004, comprising the Group's activities outside the UK, with the objective of accelerating their growth and increasing the proportion of group profit derived from non-UK businesses. After the formation of the International Division, the bank expanded its activities relatively rapidly. Colin Matthew, CEO of the International Division, said that although the Division existed to expand in markets outside the UK, the strategy was to grow "products and sectors where we had real expertise in the UK". The Division contained three principal units: activities in Australia and Ireland, the two largest businesses in terms of loans, and Europe and North America (ENA), containing its other non-UK businesses.²⁸⁶ The expansion strategy was particularly concentrated in Ireland and Australia, where BoS already had presences and where the intention was to grow both the corporate and retail activities.²⁸⁷ This annex therefore particularly analyses the Division's growth strategy in these two countries.

HBOS's activities in Australia

2. Colin Matthew presented his strategy for Australia to the Board in June 2004. His plan was for HBOS Australia to double its national market share.²⁸⁸ Four local banks dominated the Australian market, but due to "significant customer dissatisfaction" and "relatively low levels of customer commitment",²⁸⁹ there was "the opportunity for HBOS Australia to pursue a differentiated 'customer champion' proposition."²⁹⁰ The strategy planned growth in Corporate and Business Banking, Retail Banking and bancassurance, including in the East coast markets, where the Group's shares were smaller. He presented the growth strategy in Australia as "credible, manageable and low risk."²⁹¹ By June 2006 Colin Matthew told the Board that the longer term aim for the Australian business "was to become a major Australian Financial services company with market shares in the 15-20 per cent range in chosen segments."²⁹²

HBOS's activities in Ireland

3. In Ireland HBOS inherited ICC Bank, a small corporate banking business. The Group also grew a retail presence, including acquiring some branches from the Electricity Supply Board, planning to convert them into banking outlets. The local management in Ireland claimed that "the business was on target to become Ireland's second largest business bank during 2004, with the clear aim of becoming the No 1 business bank during 2005."²⁹³ A

286 ENA comprised a collection of essentially separate businesses: European Financial Services; a primarily German life, pensions and investment business; a retail banking network in Spain; a mortgage business in the Netherlands; and corporate banking in the USA and Canada.

287 Qq 1462,1558, B Ev w 238

288 B Ev w 391

289 *Ibid.*

290 *Ibid.*

291 *Ibid.*

292 B Ev w 298

293 B Ev w 390

retail products initiative was aimed to “secure 15 per cent market share in residential mortgages; 5 per cent of the credit card market; 5 per cent of household savings.”²⁹⁴

4. In 2006, HBOS’s Irish business made EUR 213m profit before tax²⁹⁵ and had EUR 27 billion of assets.²⁹⁶ In May 2007 the Irish management was targeting “in excess of EUR 500m, with over EUR 50 billion of assets”²⁹⁷ within five years. Furthermore, this rapid growth was described as “only the start of a journey towards the overall strategic goal of becoming the fourth largest full service Irish bank by 2009.”²⁹⁸ In retail markets in Ireland BoS,

had already captured an 8 per cent share of outstanding mortgage debt from a standing start and would aim to grow share by 1 per cent per annum in future. The target was to grow Retail share to 13 per cent by 2011.

HBOS also aimed to develop an enhanced Corporate proposition in Ireland, where the Division saw significant potential for growth.

HBOS’s activities in ENA

5. In 2005, HBOS’s ENA businesses made £283m profit before tax. In July 2006 their aim was to “build a business capable of delivering sustainable profit growth and £1 billion in earnings by 2011,”²⁹⁹ to be achieved by growth in all the principal businesses.

The Division’s growth

6. The Division grew rapidly from its formation 2004 to 2008. The following table summarises the growth of the International businesses in aggregate, and broken down between the individual units, from 2004 and 2008.

294 *Ibid.*

295 HBOS, *Group Business Plan 2008 – 2012: “When The Going gets Tough...”*, p 78

296 HBOS, *Group Business Plan 2008 – 2012: “When The Going gets Tough...”*, p 30

297 B Ev w 420

298 *Ibid.*

299 B Ev w 414

(£bn)	2003	2004	2004PF	2005	2006	2006PF	2007	2008	CAGR (%)
Total International									
Customer Loans									
Corporate	11.9	14.3	14.3	18.4	22.3	26.9	37.7	40.4	28.1
Of which Property and Construction	4.2	4.9	4.9	7.7	10.1	12.7	18.2	19.3	
Of which Hotels, Restaurants and Wholesale and Retail Trade	2.6	2.8	3.2	3.4	4.2	4.9	6.1	6.2	
Personal	7.0	9.2	13.6	18.0	17.0	22.0	29.7	21.7	14.5
Of which Mortgages	5.5	7.5	11.3	16.3	14.3	19.6	27.0	18.6	
Total Customer Loans	18.9	23.5	32.4	42.9	53.0	48.9	67.4	62.1	31.4
Deposits	8.1	10	10	13.9	18.3	17.5	23.6	6.6	25.2
Loans/Deposits Ratio (%)	233	235	324	309	290	279	286	941	
Impairments (£m)			186	180	221	96	116	958	
Profits (£m)			408	610	820	617	757	154	
Australia									
Customer Loans									
Corporate			8.0	10.4	13.2	13.3	18.3	10.8	31.4
Of which Property and Construction			3.1	4.5	5.9	5.9	8.7	5.3	
Of which Hotels, Restaurants and Wholesale and Retail Trade			1.2	1.6	2.2	2.2	2.7	1.0	
Personal			6.4	9.3	10.8	10.8	14.3	1.3	22.8
Of which Mortgages			5.4	8.3	9.3	9.3	13.0	0.0	
Total Customer Loans			14.6	19.7	24.5	24.6	33.3	13.0	28.5
Deposits			6	9	11.5	11.5	16.2	0.0	29.5
Loans/Deposits Ratio (%)			243	219	213	214	206	n.m.	
Impairments (£m)			19	33	59	59	81	345	
Profits (£m)			191	224	278	278	308	206	
Ireland									
Customer Loans									
Corporate			5.4	6.9	8.7	7.2	12.1	17.6	36.8
Of which Property and Construction			1.8	3.0	4.3	4.3	6.2	9.1	45.8
Of which Hotels, Restaurants and Wholesale and Retail Trade			1.7	1.8	2.1	2.1	2.6	4.1	20.9
Personal			2.7	3.9	5.4	7.0	7.5	10.7	28.6
Of which Mortgages			1.1	3.0	4.5	4.5	6.2	8.8	64.7
Total Customer Loans			8.9	12.1	15.9	16.0	22.0	31.4	36.8
Deposits			3.9	4.4	5.8	5.8	7.1	6.3	12.7
Loans/Deposits Ratio (%)			228	275	274	276	310	498	
Impairments (£m)			11	21	28	28	22	491	
Profits (£m)			97	104	149	149	184	-262	
Europe & North America									
Customer Loans									
Corporate			4.5	5.2	6.9	2.6	4.3	7.8	46.6
Of which Property and Construction			0.8	1.6	2.5	0.6	0.8	1.6	71.4
Of which Hotels, Restaurants and Wholesale and Retail Trade			0.5	0.4	0.5	0.2	0.2	0.5	31.8
Personal			4.4	5.9	5.7	5.7	7.7	9.9	22.5
Of which Mortgages			3.7	5.0	5.7	5.7	7.7	9.7	26.7
Total Customer Loans			8.9	11.1	12.6	8.3	12.0	17.7	31.8
Deposits			0.1	0.5	1.0	0.2	0.3	0.3	96.8
Loans/Deposits Ratio (%)			8900	2220	1260	4150	4000	5900	
Impairments (£m)			156	126	134	9	13	122	
Profits (£m)			120	282	393	190	265	210	

Source: HBOS Report & Accounts and 2008 full year results press release.

Note: growth rates adjusted for the effect of disposals and restatements.

300

The table illustrates the rapid pace of business growth generated by the Division during the period. Customer loans grew at an underlying compound rate of 31 per cent over the four years.³⁰¹ There was an increasing concentration in property and construction, which was 48 per cent of International corporate loans in 2008, compared with 34 per cent in 2004.

300 The growth rates in the table are adjusted for the disposal of BankWest and divisional restatements.

301 At its peak in 2007, the division represented 16 per cent of group customer loans.

7. The International Division's growth was heavily lending led. Underlying compound deposit growth was 25 per cent a year over the period. Although this growth rate is high in absolute terms, it was slower than the Division's loan growth. Furthermore, as the starting figure for customer deposits was relatively small, at £10 billion, the absolute growth in deposit volumes was smaller than the growth rate might imply. Andy Hornby explained that it proved easier to expand quickly in both economies in corporate banking than in retail banking, which is natural as retail franchises take longer to build.³⁰² Colin Matthew said that lending growth in both Ireland and Australia particularly specialised in "asset specific transactions", which led to above average concentration in CRE and related sectors in the Corporate loan books.

8. Loan growth in Ireland and Australia continued after the onset of the financial crisis. In 2008, organic, constant currency loan growth was 3 per cent in Australia and 8 per cent in Ireland. Colin Matthew considered that this growth reflected increased draw downs of existing facilities, the inability to sell down and the residential mortgage pipeline.³⁰³

9. The expansion of HBOS's international businesses was asset led, with growth in new lending exceeding growth in retail customer deposits throughout the 2004-08 period. Andy Hornby and Colin Matthew both explained that it proved relatively more difficult to grow local customer deposits than loans. Colin Matthew indicated that the plan was for the growth of the International Division initially to be funded by the Group, and, as they became more established, the international businesses were expected to grow customer deposits. However, achieving this ambition proved to be "slower than planned."³⁰⁴ The International Division's loans/deposits ratio remained relatively stable on an underlying basis, but the quantum of the customer funding gap grew materially in absolute terms. As a result of business growth over the period, the customer funding gap increased from £22.4 billion in 2004 to £55.5 billion at the end of 2008. This funding gap was not directly responsible for the Division's losses, but it was a significant factor in the overall group funding gap and materially increased the Group's wholesale funding requirement. Furthermore, the International Division was a significant factor in the Group's use of wholesale funding to support relatively illiquid customer loans. Lindsay Mackay agreed that this was a policy that would no longer be adopted.³⁰⁵

10. The strategy and performance of the International businesses were regularly reviewed by the relevant group functions, including the Group's Board, ExCo and other group committees and supervisory and control functions, as for all the main divisions. HBOS recruited local management to run its businesses in Australia and Ireland and had local boards, which had independent chairmen and both local and UK representatives. The Division's internal risk management function had both local and UK elements.

11. The Group's reporting, management and control procedures imply that International's strategy was communicated internally. No witness has indicated insufficient information was available. Andy Hornby said that he considered International risks particularly

302 B Ev w 238 and Q 1463

303 BQ 151

304 B Ev w 247, 238

305 BQ 561

carefully, because that was the area where the bank was “growing most strongly.”³⁰⁶ However, Sir Charles Dunstone commented that less time was spent on International than Corporate or Retail.³⁰⁷ Nor has any witness indicated that there were fundamental objections at any of the various levels to the International Division’s strategy or exposures, though several referred to appropriate levels of consideration and debate. However, the procedures failed to prevent and indeed sanctioned, the growth of the Division. Colin Matthew suggested that “the issue of distance was a consideration.”³⁰⁸

The Division’s impairments

12. Significant impairments were charged in Ireland and Australia by HBOS in 2008 and LBG in 2009-11, as illustrated in the following table:

HBOS impairments in Ireland and Australia

(£m)	Ireland	Australia
2008	491	345
2009	2,949	849
2010	4,264	1,362
2011	3,187	1,034
Total 2008-11	10,891	3,590
2008 loan book (£bn)	30.7	13.0
Impairments/Loans (%)	35.5	27.6

Source: HBOS 2008 full year results press release and Lloyds Banking Group Annual Report & Accounts

LBG charged a further £897m of impairments against Ireland and £203m against Australia in the first half of 2012.³⁰⁹

Impairments against HBOS’s business in Ireland

13. The estimated impairments against Ireland totalled £10.9 billion between 2008 and 2011, which is equivalent to 36 per cent of the Division’s loan book at the end of 2008. The sterling figures actually benefit from the deprecation in the EURO over the period and would be some 5 per cent worse in local currency terms. CRE was the principal factor in the impairments; 60 per cent of impaired loans in Ireland at the end of 2011 related to CRE exposures.³¹⁰

14. All leading Irish banks incurred significant impairments, as a result of the Irish recession. However, the losses at HBOS were relatively greater than those of the other major Irish banking groups, as the following table shows:

306 Q 1468

307 BQ 838

308 B Ev w 249

309 “2012 Half-Year results”, *Lloyds Banking Group News Release*, p 123

310 Lloyds Banking Group, *2011 Annual report and Accounts: Becoming the best bank for customers*, p 155

**Leading Irish Banks' Cumulative Loan impairments
(2008-11 as % of end 2008 loans)**

AIB	22.1
Anglo Irish	48.3
BoI	9.4
Danske	17.9
HBOS	35.5
ILP	6.1
KBC	6.7
Ulster	17.5

Source: Company data

15. HBOS's impairments as a proportion of loans were the second highest of the major banking groups in Ireland. There is also a very significant gap between the HBOS proportion and the next highest figure.

Impairments against HBOS's business in Australia

16. The estimated impairments against Australia totalled £3.6 billion in the 2008-11 period, equivalent to 28 per cent of the Division's loan book at the end of 2008. The figures are increased by the appreciation of the Australian dollar against sterling during the period, which we estimate added some 20 per cent to the sterling figure for impairments. However, even allowing for this, impairments would still have totalled over 20 per cent of the loan book in local currency terms. The Australian economy has been one of the most resilient in the world, and impairments there for the leading banks have been amongst the lowest as a proportion of the loan book of any major banking system.

17. The International Division's Australian impairments would have been material to the HBOS Group as a whole in absolute terms. They were also high relative to the Australian corporate loan book – indeed, as a proportion of the loan book, they were higher than those of the Corporate Division.

Losses in HBOS's International Division

18. We estimate that the impairments taken against Ireland and Australia in the 2008-11 period total £14.5 billion.³¹¹ Senior former HBOS executives described the losses in HBOS's International Division as “appalling”,³¹² “catastrophic”,³¹³ and “horrible”,³¹⁴ and gave a range of explanations as to their cause. Many referred to the seizure in financial markets generally, including that they particularly affected asset markets, which in turn, particularly

311 Lloyds Banking Group (LBG) does not publish divisional figures for HBOS, but it is possible to estimate the impairments subsequently required in Ireland and Australia. LBG does disclose impairments in Ireland and Australia for the enlarged group. Reconciling the HBOS 2008 press release disclosure on the International division (pp 32-41) with the combined figures for LBG in its 2009 Annual Report & Accounts (p 37), it can be shown that substantially all the LBG customer loans in Ireland and Australia were originally loans made by HBOS. This would also be logical as the former Lloyds TSB did not have the local presence in these markets that HBOS did. We therefore assume that the LBG impairments in Ireland and Australia relate to former HBOS exposures. It is not possible to estimate impairments taken against the ENA portfolio, as LBG disclosure is likely to include charges against loans originated by Lloyds TSB.

312 Q 1293

313 Q 1463

314 Q 1557

affected the HBOS businesses, due to their CRE exposure. Most witnesses also referred to the problems in the Irish economy and the losses of banks in Ireland generally. Some accepted that these factors alone could not explain the scale of HBOS's international impairments, particularly relative to the losses incurred by other local banks. A few witnesses accepted that the scale of losses implied mistakes on the part of the HBOS Group. Colin Matthew said that, with the benefit of hindsight, the "principal weakness" in the approach the Division followed was that "the expansion plans were wrongly timed", but he defended other aspects of the Division's strategy.³¹⁵ Jo Dawson later assumed responsibility for the former HBOS businesses in Ireland and Australia, when at LBG. She claimed that she then became aware of significant asset quality issues and the need to strengthen risk management.³¹⁶

19. HBOS's losses in the International Division were in large part due to the Division's strategy. The Division followed an ambitious growth strategy in Ireland and Australia, involving over-optimistic targets and assumptions for market share growth from local competitors. The Division's pursuit of rapid business growth led to a concentration in higher risk corporate areas, notably in CRE and related sectors, rather than in potentially more sustainable and less risky areas, which would have involved a slower build. The specific nature of the Division's loan portfolio resulted in higher credit losses. The nature of the losses mirrored those incurred in HBOS's UK Corporate Division. After the Corporate Division, the International Division was the next most significant source of HBOS's impairments. While the International Division's losses were smaller than in Corporate in absolute terms, they were significantly bigger as a proportion of the loan book in both Ireland and Australia. While all major banks suffered high losses in Ireland, HBOS's were by a significant margin the second worst as a proportion of the loan portfolio. The company also incurred heavy losses in Australia, where the economy and the banking industry have been relatively resilient. The evidence from those two countries clearly suggests that HBOS had significantly worse asset quality than other banks.

315 B Ev w 248

316 B Ev w 186

Annex 3: The Treasury Division

Introduction

1. HBOS's Treasury Division had three objectives, which were (in order of priority): managing the Group funding and liquidity position; providing treasury products and services to Group customers; and generating profits as a profit centre in its own right.³¹⁷ We examine Group funding and liquidity in the next annex of this Report. In this annex, we consider the effects of the asset portfolio the Treasury Division built up.

The Division's changing asset portfolio

2. As noted above, profit generation in its own right was the third and least important of the Treasury Division's functions, and several witnesses emphasised the Division's conservative approach. In 2001, 99 per cent of the Treasury Division's assets were rated A or better, and 86 per cent were AAA.³¹⁸ At the end of 2006, the proportion rated A or above remained above 99 per cent.³¹⁹ The Division closed its proprietary interest rate trading activities in 2005.³²⁰

3. The Division originally established a structured investment portfolio to manage the excess capital within Halifax,³²¹ and the HBOS Group maintained a large liquidity portfolio as deliberate protection against the size of its wholesale funding.³²² The Division had £18 billion of structured credit assets which were from Halifax and which predated the merger. The Division increased this to some £40 billion by the end of 2008, and had another £40 billion in a combination of government bonds and bank paper.³²³

4. By 2004, the Treasury Division had developed a strategy to diversify the portfolio of liquid assets from what was regarded as an over-reliance on government bonds and bank certificates of deposit (CDs):

Alternatives were being developed to build new pockets of liquidity; to develop new products – for example, in Credit Derivatives – that would have superior returns and liquidity characteristics; to lower the cost of high quality liquid assets; and to leverage expertise to create income.³²⁴

Consequently, the Treasury Division held significant portfolio of debt securities at the end of 2007, as summarised in the following table.

317 HBOS, *2007 Annual Report and Accounts: Delivering our strategy...*, p 60. Asset Management was not material to the group's financial results, still less its failure and therefore this annex deals exclusively with Treasury activities.

318 HBOS, *2001 Annual Report and Accounts: The New Force*, p 32

319 HBOS, *2006 Annual Report and Accounts: Our strategy has five key elements to create value*, p 73

320 B Ev w 242

321 B Ev w 385 - 386

322 BQ 472

323 BQq 440, 472, 580, 593

324 B Ev w 385

Treasury Debt Securities Holdings (£bn)	
Asset Backed Securities	
<i>US RMBS</i>	9.5
<i>Other US RMBS</i>	8.0
<i>CMBS</i>	3.3
<i>CDOs</i>	6.6
<i>Negative Basis</i>	3.3
<i>Personal Sector</i>	5.3
<i>FFELP Student Loans</i>	5.7
<i>Other ABS</i>	0.2
Total ABS	41.9
Covered Bonds	3.2
Floating Rate Notes	15.8
Bank CDs	16.9
Other	3.4
Total	81.2

Source: HBOS 2007 Annual Report & Accounts p63-64.

5. The Division's US residential mortgage backed securities (RMBS) portfolio included £7.1 billion in Alt-A backed loans. The investments included £5.1 billion in exposure to monoline insurers in the form of negative basis trades and guarantees.³²⁵ The Division held an increasingly significant portion of its assets via conduits. The most significant of these was Grampian.³²⁶ Grampian had a balance sheet of £19 billion (ie 23 per cent of the Division's debt securities holdings at the end of 2007), all of which was held in asset backed securities (ABS) (ie 44 per cent of the Division's ABS holdings).³²⁷

6. Philip Hodkinson, Group Finance Director from 2005 to 2007, claimed that, because the Treasury Division arranged UK mortgage securitisations, it had "a good level of expertise in the ABS market."³²⁸ Indeed, in sourcing assets, the Treasury Division always made its own decisions, rather than relying on external credit ratings.³²⁹

325 This total comprised £2.8 billion through negative basis trades and £2.3 billion in 'wraps' on other bonds. HBOS, 2007 Annual Report and Accounts: *Delivering our strategy...*, pp 63-64

326 Grampian was established in 2003, with an initial targeted size of \$6 billion, as the then existing conduit, Pennine, had reached its maximum size of \$12 billion (B Ev w 277 - 278). Grampian later replaced Pennine. Grampian sought to fund its investments by raising funds on the wholesale markets, notably in commercial paper. After the beginning of the financial crisis, in common with many other similar vehicles, Grampian became unable to fund itself from third party sources at acceptable rates and was forced to rely on the Group (HBOS, 2007 Annual Report and Accounts: *Delivering our strategy...*, p 67).

327 HBOS, 2007 Annual Report and Accounts: *Delivering our strategy...*, p 63

328 B Ev w 232

329 BQ 590

7. The diversification of the liquidity portfolio resulted in the increase in the structured investment portfolio. Although this was still viewed by the Group as low risk, the Executive Committee understood that the risks were increasing.³³⁰ However, outside Treasury, HBOS senior management, including the Board relied on external ratings in its assessment of risk, rather than an understanding of the instruments themselves. Jo Dawson, group risk director in 2006 and subsequently a Board member said that she “would not have known what an Alt-A security was” and that the Treasury Division was given a mandate to invest in a particular credit rating.³³¹

The Division's losses

8. The Treasury Division took £7.2 billion of profit and loss account charges against its assets between 2008 and 2011. In 2008, Treasury incurred £3.95 billion of ‘market dislocation losses’ on its investments, as a result of the financial crisis, comprising £1.4 billion of impairments and £2.5 billion of negative fair value adjustments. The losses resulted in an overall pre-tax loss of £3.6 billion for the Treasury Division in 2008. The bank also took £4 billion of negative fair value reserves direct to equity.³³² In the 2009-11 period a further £1.3 billion of impairments were charged against Treasury assets classified as loans and receivables and a total of £1.9 billion of the negative fair value reserves against available for sale assets were taken through the profit and loss account.

330 B Ev w 302

331 BQq 270-271

332 HBOS, 2008 *Annual Report and Accounts*, pp 11, 44

Annex 4: The Retail Division

Introduction

1. The Retail Division was the largest division in HBOS in terms of customer loans and generally of profits. The Division combined the retail banking activities of Halifax, primarily in mortgages and savings under the Halifax and other brands, with those of BoS, which comprised a branch banking business in Scotland and products delivered through direct channels throughout the UK. The enlarged HBOS Retail Division was arguably the leading UK retail financial services business. It had market leading positions both in mortgages, with a 20 per cent share of new mortgages written in 2008, and in deposits, with a 13.2 per cent share of Household Liquid Assets at the end of 2008.³³³ During the period following the merger, the Retail Division broadened its activities, increasing its shares of financial service products other than mortgages and deposits. The Division achieved a 16 per cent share of new UK current accounts in 2008, when it also had a 10 per cent share of unsecured lending balances and 11 per cent of new credit card accounts. The Retail Division was also the leading UK bank distributor of insurance, both investment and general insurance products.³³⁴

The Division's strategy

2. From the point of the merger the Retail Division followed a strategy positioning itself as the "customer's champion," claiming that it offered "outstanding value for money" right across its product range and products and prices that were "easy to understand."³³⁵ The Retail business was the one division in HBOS that held a leading incumbent position, in the form of its mortgages and savings business, which was a potential opportunity for competitor banks. At the time, the mortgage market saw a significant increase in competition from existing players and new entrants, particularly due to the abundance of wholesale funding at attractive rates. However, HBOS saw itself as a challenger organisation in most other retail financial service products, with the opportunity to gain share by distributing them to its existing customer base. Consequently, the Retail strategy involved managing the effects of competition on its mortgages and savings business, while increasing its share in other products.

3. A key element of the Division's mortgage strategy was to grow 'non-standard' mortgage lending, particularly buy-to-let and self-certified mortgages, where margins had remained higher than with standard mortgages and the overall profitability was thought to be more attractive, despite higher credit risks.³³⁶ At the end of 2003, £36 billion (20 per cent) of the Division's portfolio was classified as non-standard.³³⁷ By the end of 2008, this figure had risen to £66.5 billion of mortgage lending (28 per cent)³³⁸. As a result, 35 per cent of the Division's book had a loan-to-value ratio of over 70 per cent by the end of 2007, and this

333 HBOS, 2008 *Annual Report and Accounts*, p 7

334 HBOS, 2007 *Annual Report and Accounts: Delivering our strategy...*, p 16

335 HBOS, 2001 *Annual Report and Accounts: The New Force*, pp 12-13

336 HBOS, 2003 *Full Year Results Presentation*, lloydsbankinggroup.com, slide 27

337 "HBOS plc Preliminary Results 2004: Stock Exchange Announcement", HBOS Press Release, 2 March 2005, p 13

338 "HBOS plc Preliminary Results 2008: Stock Exchange Announcement", HBOS Press Release, 27 February 2009, p17

proportion rose to 62 per cent by the end of 2008³³⁹, due to the fall in house prices. These proportions are significantly higher than for any other mainstream mortgage lender, which makes the Division's portfolio more vulnerable to a housing market downturn than those of other leading mortgage banks.

4. The strategy of expanding shares in products outside mortgages and savings was successful in increasing shares as outlined in paragraph 1 of this annex. The Retail Division unsecured loan book totalled £16.7 billion at the end of 2008.³⁴⁰ Retail also built significant shares in new current accounts and the distribution of insurance products. At the end of 2008, the Retail Division had customer deposits of £144 billion and customer loans of £255 billion, a gap of £111 billion.³⁴¹ The Division was therefore the largest element in the overall HBOS group customer funding gap, representing over half the Group's total funding gap of £213 billion at the end of 2008.³⁴²

The Division's impairments

5. As LBG does not publish divisional results for the HBOS Group, it is not possible to know precisely the impairments the Retail Division has incurred since the financial crisis. We do, however, know the figures for 2008. The HBOS 2008 disclosure shows Retail impairments of £2.2 billion, of which £1.1 billion was against secured lending, up from just £28m in 2007.³⁴³ By contrast, Lloyds TSB only incurred impairments of approximately £170m against mortgages in 2008. In order to get an idea of the size of HBOS's mortgage impairments for 2009-11, it is possible to look at the aggregate LBG Retail impairments against secured lending for the period, which were £1.5 billion.³⁴⁴ Assuming the bulk of LBG impairments against mortgage lending continued to be related to HBOS loans, we estimate that HBOS mortgage impairments for the 2008-11 period would have been some £2 billion (which represents 1 per cent of the 2008 book of secured loans).

6. There was a general deterioration in UK banking industry unsecured loan arrears experience in the early part of the last decade. HBOS was no exception. As a result, the bank tightened its unsecured lending criteria in 2004.³⁴⁵ Consequently, the Retail Division's unsecured lending grew relatively moderately in subsequent years, averaging annual growth of 3 per cent in between 2003 and 2008. However, the Division's impairments continued to rise, initially because the lending it wrote in 2002-03 'seasoned' and thereafter because of the economic downturn. The Division's unsecured impairments were £486m in 2003 and £1.1 billion in 2008, averaging about £1 billion a year over the 2003-08 period;³⁴⁶ and we estimate that they continued at a similar level subsequently. These figures would be equivalent to annual impairment charges of 7 per cent of loans per year, which shows that

339 *Ibid.*, p17

340 *Ibid.*, p17

341 HBOS, *2008 Annual Report and Accounts*

342 *Ibid.*, p 42

343 HBOS 2008 full year results press release, p 15

344 "HBOS plc Preliminary Results 2008: Stock Exchange Announcement", HBOS Press Release, 27 February 2009

345 HBOS, *2004 Annual Report and Accounts: Making growth work harder for shareholders*, p 11

346 HBOS Annual Reports and Accounts for the years 2003 – 2008.

HBOS's unsecured loan charges were generally significantly larger than for its mortgage portfolio, both in absolute terms and as a proportion of the book.³⁴⁷

7. Although experiencing some deterioration as a result of the crisis, particularly in respect of non-standard mortgages, HBOS's Retail impairments were substantially less than either the Corporate or International Divisions incurred and were not a material factor in the failure of HBOS. We estimate that total Retail impairments would have been some £7 billion between 2008 and 2011. The Division generated profits before impairments of £3.5 billion in 2008.³⁴⁸ Even allowing for significant pressure on this figure in subsequent years and for charges against the mis-selling of payment protection insurance, the Division's pre-impairment profits would have allowed the Group to absorb the likely level of impairments and still generate profits.³⁴⁹

8. The prime reason for the resilience of the Retail Division was the resilience of its credit quality. There are likely to have been several factors for this. The Retail business was the market leader in mortgages and savings. It was not a relative new entrant, unlike the International Division and, to a lesser extent, the Corporate Division. The market position of the Retail Division was therefore stronger, and it generated higher quality business. Group senior management and central risk functions had greater understanding of the Retail business and several had direct expertise having worked on the Retail side. There was therefore greater involvement by senior management and central functions in Retail and greater willingness to accept that on the part of the Division.

9. The Retail Division participated in higher risk mortgage segments and grew the proportion of higher risk lending. However, such business remained a minority of its mortgage exposure, with mainstream mortgage loans still 72 per cent of the mortgage portfolio at the end of 2008. This focus is in contrast to HBOS's corporate lending, both domestically and internationally, where the divisions adopted a strategy of specialisation in higher risk segments, including CRE. The downturn in the residential property market was not as pronounced as in the commercial property area, which resulted in significantly less pressure on mortgage asset quality than on CRE. Should there be a downturn in the residential property market, the higher LTVs resulting from HBOS's growth in non-standard mortgages would be likely to make its portfolio more vulnerable than those of other leading mortgage banks.

10. Although the Retail Division incurred higher losses than its major competitors and still today retains higher risks in its mortgage portfolio, it was not a major contributory factor in the failure of HBOS. The Division is likely to have remained profitable during the crisis period and subsequently, albeit at a reduced level. Nonetheless, the Division's customer funding gap was a major factor in the Group's overall funding gap.

347 Interest margins on unsecured lending would, of course, have been materially higher to compensate for this fact.

348 HBOS, *2008 Annual Report and Accounts*, p 7

349 This calculation is still likely to hold true, even if the £1,155m of charges taken by HBOS against mis-selling of payment protection insurance in 2011 are included.

Annex 5: Funding and Liquidity

Introduction

1. Both Halifax and BoS were significant users of wholesale funding, and HBOS had a significant reliance on wholesale funding from the outset. Both the bank and the regulator recognised early on that this reliance on wholesale funding represented a strategic weakness. However, neither addressed this sufficiently.

HBOS's funding gap

2. The main features of HBOS's use of wholesale funding are summarised in the following table.

(£bn)	2001	2002	2003	2004	2005	2006	2007	2008
Customer Loans	201.3	240.9	283.5	315.6	343.8	376.8	430.0	435.2
Customer Deposits	140.5	150.2	173.5	195.5	200.9	211.9	243.2	222.3
Loans/Deposits Ratio (%)	143	160	163	161	171	178	177	196
Customer Funding Gap	61	91	110	120	143	165	187	213
o/w Retail	40	59	76	78	87	93	95	112
o/w Corporate	34	42	44	34	38	50	65	78
o/w International	not disclosed			22	29	31	44	54
Wholesale funding	107.6	135.5	153.5	157.9	235.3	231.0	278.0	238.0
(o/w less than one year maturity)	89.8	108.7	113.5	106.1	138.7	121.2	164.1	119.4

Source HBOS Annual Report & Accounts

Notes Wholesale funding in 2006-08 as disclosed in the HBOS Report & Accounts and excludes repo activity and the funding raised in conduit names.

Wholesale funding prior to 2006 is defined as interbank deposits, debt securities and subordinated liabilities.

3. From its formation HBOS had a large wholesale funding requirement, as both Halifax and BoS were already significant users of wholesale funding even prior to the merger. At the Group's formation in 2001, the Group had a loans/deposits ratio of 143 per cent and a customer funding gap of £61 billion. The Retail Division, which had been substantially derived from Halifax, had customer loans of £137 billion and deposits of £97 billion – a customer funding gap of £40 billion.³⁵⁰ The rest of the HBOS Group, substantially derived from BoS, had a customer funding gap of £21 billion.

4. By the end of 2008 the loans/deposits ratio had risen to 196 per cent and the customer funding gap had increased to £212.9 billion. The Retail Division's customer funding gap had risen to £112 billion, the Corporate Division had a gap of £78 billion, and the International Division a gap of £54 billion. All three of the Group's principal banking divisions contributed to the increase in the Group overall customer funding gap and the greater need for wholesale funding over the 2001-08 period. Lindsay Mackay, HBOS Treasury CEO from 2004, confirmed that from the beginning HBOS adopted a strategy to increase wholesale funding aggressively to support asset growth.³⁵¹

The profile of its wholesale funding

5. HBOS's wholesale funding included significant sums of relatively short term maturity. Although the proportion of wholesale funding with a maturity of under one year fell from 83 per cent in 2001 to 50 per cent in 2008, the quantum of shorter duration funding

350 HBOS, 2002 Annual Report and Accounts: 'Even in tough markets, this is the strategy that delivers', p 7

351 BQ 537

increased from £90 billion at the beginning of the period to £119 billion at the end, peaking at £164 billion at the end of 2007.

6. The financial crisis resulted in a shortening of the wholesale funding profile, as maturing longer term funding could only be replaced by shorter duration maturities.³⁵² This change resulted in the proportion of HBOS's wholesale funding with a duration longer than one year falling from 47 per cent at the beginning of the crisis in mid-2007 to just over 40 per cent one year later.

Failures to reduce a known risk

7. Both the bank and the regulator clearly identified funding as an important issue and a potential strategic weakness from a very early stage. The FD explained to the Group Board in November 2002 that the five-year business plan would make HBOS "the largest wholesale funded clearing bank in the UK", and the CEO acknowledged that funding was a "significant risk."³⁵³ However, as indicated by Sir James Crosby, funding was seen as a risk to growth plans, rather than as a threat to the existence of the bank.³⁵⁴ The FSA conducted a review of HBOS in December 2002, which drew attention to the liquidity risk and stressed the need for the bank to have a robust wholesale funding plan arising from the Group's projected asset growth.³⁵⁵

8. Although the overall strategy was to increase wholesale funding, HBOS took steps to mitigate its reliance, including: increasing the efforts to source customer deposits; lengthening the wholesale funding maturity profile, particularly by increasing the proportion of funds with a maturity greater than one year;³⁵⁶ diversifying wholesale funding sources by nature, currency and type of investor;³⁵⁷ holding a significant pool of liquid assets; and undertaking stress tests and scenario analyses.³⁵⁸ However, none of these steps fully succeeded.

9. HBOS's attempts to increase customer deposits were unsuccessful in reducing its wholesale funding requirement. The Group's loans/deposits ratio increased progressively in every single year, apart from 2003 and 2004. Moreover, as the loans/deposits ratio was over 100 per cent at the beginning of the period and the balance sheet grew progressively, the quantum of the increase in customer funding gap in absolute terms was proportionately greater. Lindsay Mackay explained that the Group attempted to attract high quality retail deposits and avoid "hot, volatile" funds.³⁵⁹

10. The Group did diversify its sources of wholesale funding. Wholesale funding included covered bonds, securitisations and senior debt. It also raised funds in different currencies.

352 BQq 539 - 540

353 B Ev w 346 - 349

354 Q 1328

355 B Ev w 449

356 The proportion of wholesale funding with a maturity of under one year decreased from 83 per cent in 2001 to 50 per cent at the end of 2008.

357 The Group's wholesale funding included covered bonds, securitisations and senior debt. It also raised funds in different currencies. However, the US dollar funding proved to be relatively volatile over the crisis and the HBOS balances from this source approximately halved in 2008.

358 BQq 345, 437, 440, 472, 529

359 BQ 529

However, in the event, US dollar funding proved to be relatively volatile over the crisis and the HBOS balances from this source approximately halved in 2008.³⁶⁰ The proportion of wholesale funding with a maturity of under one year decreased from 83 per cent in 2001 to 50 per cent at the end of 2008.

11. HBOS's £60 billion liquid assets pool also proved ineffective, as the bank was unable to sell or raise funds against it in the crisis, due to the seizure of wholesale markets.³⁶¹ Indeed, the market's concerns about potential losses in HBOS's investment and liquidity portfolios actually contributed to the market's increasing concerns about the bank.³⁶² HBOS was forced to supply liquidity to the Grampian conduit, which was unable to finance itself on the wholesale markets at attractive rates.³⁶³

12. The bank ran stress tests on its funding model, notably: the assumption of a two notch downgrade; and also the wholesale markets suffering a one in 25 or 30 year stress event, including the complete closure of one of the bank's main funding sources.³⁶⁴ The liquidity portfolio was expected to cover outflows for over one month, assuming no market access,³⁶⁵ which was much more than the then regulatory minimum of 8 days outflows.³⁶⁶ By 2006 it also maintained a policy that a minimum 40 per cent of wholesale funding had to have a residual maturity over one year and a maximum of 25 per cent under one month.³⁶⁷ These policies would still allow customer lending to be funded by short term funding of under one year and even under one month duration.

13. All HBOS witnesses accepted that management did not expect, still less make contingency planning for, the severity of the financial crisis, including the near closure of term wholesale money markets to banks for over a year.³⁶⁸ All senior management accepted that their failure to plan for such a severe funding and liquidity crisis as occurred was an error and many of them apologised for it. However, most of them also argued that the scale and duration of the crisis were almost unprecedented and unforeseeable.

A consequence of the bank's strategy

14. As we saw in the introduction to the previous section, the Treasury Division's first priority was sourcing the funding to support the Group's asset led strategy.³⁶⁹ Management papers throughout the period show that the planned asset growth posed challenges for the Treasury Division in raising the funding to support it, even before the onset of the financial crisis. The 2003-07 Business Plan (drawn up in 2002) cited funding and liquidity as possibly the bank's "greatest single challenge."³⁷⁰ Lindsay Mackay told the Executive

360 HBOS, *2008 Annual Report and Accounts*, p 27

361 BQ 440

362 BQ 472

363 HBOS, *2007 Annual Report and Accounts: Delivering our strategy...*, p 97; HBOS, *2008 Annual Report and Accounts*, p 28

364 Bq 440, Q 1450

365 Q 544

366 *Ibid.*

367 B Ev w 243

368 Qq 1288, 1464

369 HBOS, *2007 Annual Report and Accounts: Delivering our strategy...*, p 60

370 HBOS, *Secret 20/20 vision Group Business Plan 2003 – 2007*, p 61

Committee in 2006 that the bank's existing wholesale funding capacity would be reached in 2009 under their current Plan. HBOS had "the highest wholesale funding need of any of the UK banks (and was close to the other Big Four banks combined)." He recognised that, in the longer term, the position was "untenable and unsustainable".³⁷¹

15. Lindsay Mackay stressed that the targets for wholesale funding were agreed with Treasury, rather than dictated to it. Asset growth targets went through several iterations in the planning process, between the lending divisions as "consumers of the funding"³⁷² and the Treasury Division's view of what was achievable. He claimed that he was always comfortable that the funding targets assumed in the business plans were achievable as he would not have supported a plan if that had not been the case.³⁷³

16. In the initial period after the merger, the divisional CEO of Treasury, Gordon McQueen was a main Board member. However, his successor as Treasury CEO, Lindsay Mackay, did not sit on the Board, though he was an ExCo member. Lindsay Mackay reported to a succession of main Board members, George Mitchell, CEO of Corporate, then Phil Hodkinson, as Group FD, and subsequently Colin Matthew, CEO of International. At times therefore, Lindsay Mackay as CEO of the Treasury Division was reporting to main Board directors, who were heads of divisions whose asset growth relied on funding Treasury was charged with raising.

The impact of the financial crisis

17. Once the financial crisis began, HBOS did constrain its asset growth. However, several executives said that the reliance on the markets for wholesale funding made the Group cautious about the signals it was sending: being too aggressive in scaling back growth risked worrying the market that the bank might be in difficulty.³⁷⁴ In September 2007, Philip Hodkinson outlined to the Executive Committee steps to reduce asset growth and increase liabilities, although full-year asset growth would still be above Plan. However, he also indicated, lending "could not simply be 'turned off.'"³⁷⁵ The Executive Committee subsequently reduced asset growth targets for 2008 by £10 billion, largely in International, with Retail and Corporate asset growth already constrained as much as desirable. In addition, the Group targeted increased liability growth. Funding would be reviewed monthly throughout 2008.³⁷⁶ However, Mike Ellis accepted that these measures were a matter of judgement and might appear insufficient in hindsight.³⁷⁷ Furthermore, the achievement of the revised targets proved challenging.³⁷⁸

18. Philip Hodkinson said that the responses to stressed conditions, which the Group had prepared and which took effect in late 2007, together with other measures, were working and the Group felt "in good shape."³⁷⁹ Peter Hickman indicated that the Group's liquidity

371 B Ev w 319

372 BQ 549

373 BQq 548, 550, 567

374 BQq 355, 496

375 B Ev w 326

376 B Ev w 330, 333-334

377 BQ 356

378 B Ev w 433

379 BQ 440

planning and measures to lengthen the maturity of its funding protected the Group initially and without them, it would have faced difficulties more quickly than it did.

19. Successive Executive Committee and Board papers during the financial crisis indicate management took the funding position seriously. The day after the announcement that Northern Rock had been granted emergency Bank of England assistance, HBOS set up a Contingency Planning Group, and the CEO indicated planned business growth was no longer prudent.³⁸⁰ On 18 September 2007, Lindsay Mackay discussed with the Executive Committee contingency planning designed to avoid HBOS becoming “the next Northern Rock.”³⁸¹ Initially at least, the management believed that the external perception was that the bank had “managed its position through the liquidity crunch extremely well.”³⁸² It felt regarded as one of the larger Clearing Banks, distinct from the monoline or smaller mortgage banks.³⁸³ However, as the crisis progressed, the HBOS credit default swap levels widened, both in absolute and relative terms.³⁸⁴ The Group suffered an attack from short sellers on 18 March 2008, which led to the withdrawal of some deposits that stabilised after an FSA statement. The market was also concerned with the structure of the HBOS balance sheet, notably its loans/deposits ratio and the absolute size of its wholesale funding.³⁸⁵

20. Peter Hickman asserted that the purpose of most liquidity planning was “to get you through a short term crisis.” He believed that the Group “weathered a remarkable storm very well.” Lindsay Mackay indicated that in the second quarter of 2008 funding conditions appeared to be easing somewhat. However, by October 2008, the extended closure of markets at the long end, and then the total closure of markets to essentially all but overnight funding and the withdrawal of customer funds following the Lehman bankruptcy exhausted the Group’s resources.³⁸⁶

21. As the crisis continued, the inability to raise term wholesale funding led to a progressive shortening of the wholesale funding duration. Lindsay Mackay also said that, following the Lehman bankruptcy, HBOS suffered £30-35 billion of customer deposit outflows, which were bigger than the wholesale funding strains and could not be offset by additional wholesale funding, as by this stage, the Group had actually significantly exceeded its planned assumptions for wholesale funds.³⁸⁷ It was the exodus of customer deposits, rather than the wholesale funding position alone, which was the final trigger for the Group’s collapse.³⁸⁸ The 2008 Annual Report & Accounts indicates that the majority of this outflow was by non-bank financial and large corporate, rather than retail, customers.³⁸⁹

22. Due to its inability to fund customer withdrawals and maturing liabilities, HBOS was forced to accept ELA assistance from the Bank of England on 1 October 2008 – 14 months

380 B Ev w 321

381 B Ev w 325 - 326

382 B Ev w 422

383 B Ev w 325 - 326

384 B Ev w 427

385 BQ 472

386 BQq 533, 572

387 BQq 533, 571

388 BQ 571

389 HBOS, 2008 Annual Report and Accounts, p 26

after the beginning of the financial crisis and over 12 months after Northern Rock's announcement that it had been granted emergency Bank of England support.

23. Michael Foot explained that HBOS's liquidity problems "were in significant part caused by doubts about the quality of its asset book. Liquidity does not dry up for no reason – it dries up in some places more than others."³⁹⁰

24. The combination of poor quality, illiquid assets and wholesale funding compounded the risks involved in each. Both Andy Hornby and Lindsay Mackay accepted that HBOS's use of wholesale funding to support commercial property and other assets where competitors were also wholesale funded did "not make sense" and "was a major strategic weakness."³⁹¹

25. Liquidity and funding were the immediate but not underlying cause of HBOS's collapse. HBOS had the highest wholesale funding need of any of the UK banks (and was close to the other Big Four banks combined). In the words of the CEO of the bank's own Treasury Division, in longer term, the position was "untenable and unsustainable". The Group's extraordinary reliance on wholesale funding made it particularly vulnerable to the liquidity crisis. The prolonged closure of markets to term funding progressively shortened the duration of the HBOS wholesale liabilities, as maturing funds were only able to be refinanced at short maturities. This was compounded by the market's concern over HBOS because of the size of its wholesale funding. After the Lehman failure, HBOS then suffered from the complete closure of markets and a sudden withdrawal of customer deposits, particularly from corporate and overseas customers.

26. Both Halifax and BoS had been significant users of wholesale funding. HBOS's reliance on wholesale funding was identified as a strategic weakness right from the start, by both the Group and the regulator. The bank's Board and Executive Committee and supervisors regularly reviewed this risk, and they were all aware that HBOS had a disproportionate reliance on wholesale funding compared with other large UK banks.

27. The Group did take measures to mitigate its wholesale funding reliance: increasing the emphasis on raising customer deposits; lengthening the average maturity, by increasing the proportion of funds with a maturity of over one year; diversifying the sources of its wholesale funding by type and currency; holding significant liquidity. However, these measures were secondary to the continuation of asset growth. In particular, the absolute size of wholesale funding with a maturity of under one year increased during the 2001-08 period. The benefits of lengthening the maturity of funding went to supporting asset growth, rather than reducing the exposure to short term funding in absolute terms. Elements of the liquidity pool were invested in assets which increased their yield, but proved illiquid and a source of impairments in the crisis. The Group's strategy was based on asset growth. Although Treasury was actively involved in business planning and believed it could raise the funding required, its status was secondary to the lending divisions. Regulatory liquidity standards then applying were inadequate.

28. The stress tests the company itself ran, including a one in 25 year event, were also inadequate, although more conservative than regulatory standards then applying.

390 BQ 1069

391 BQ 573, Q1448

However, even more conservative funding assumptions would have been unlikely to include the severity of the financial crisis.

29. The management took the financial crisis seriously and reacted relatively rapidly, slowing asset growth and seeking to grow deposits more rapidly. However, its ability to take mitigating action was constrained by: the collapse in wholesale market liquidity; other banks also targeting deposit growth; a desire not to increase market concerns by reacting more aggressively to constrain asset growth in particular. Management could have been more aggressive in its response to the crisis, although such action would have been unlikely to have affected the outcome.

30. In the early stages of the crisis, the Group's position was not regarded as being as vulnerable as some smaller mortgage banks. It finally succumbed to liquidity pressures more than a year after Northern Rock received Bank of England assistance and 14 months after the beginning of the crisis. However, as the crisis continued market concerns towards HBOS specifically progressively increased. Elements of the Group's investment portfolio proved less liquid than expected and even contributed to asset quality concerns.

Although liquidity and funding were the immediate causes of the HBOS collapse, they were not the fundamental issue, which was solvency, or at the very least, failure would just have occurred at a later stage, as the subsequent impairments threatened solvency. Furthermore, if HBOS's problems had been limited to funding, no equity injections by HMT or LBG would have been necessary and there would have been no losses to the UK taxpayer; liquidity support alone would have been sufficient and such support that the company did receive has been repaid. Furthermore, there is a strong likelihood that the liquidity and funding pressures were exacerbated by the market's concerns over solvency, including its ABS portfolio and the nature of its loan book, concerns that proved to be correct, in addition to concerns over its funding structure.

Formal Minutes

Thursday 7 March 2013

Members present:

Mr Andrew Tyrie MP, in the Chair

The Lord Archbishop of Canterbury
Mark Garnier MP
Baroness Kramer
Rt Hon Lord Lawson of Blaby
Mr Andrew Love MP

Rt Hon Pat McFadden MP
Rt Hon Lord McFall of Alcluith
John Thurso MP
Lord Turnbull KCB CVO

Declarations of interest, by members of the Commission, relating to the Commission's work were made on 24 July 2012 and 8 November 2012.

Draft Report ('*An accident waiting to happen: The failure of HBOS*'), proposed by the Chair, brought up and read.

Ordered, That the draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 141 read and agreed to.

Annexes agreed to.

Resolved, That the Report be the Fourth Report of the Commission to each House.

Ordered, That the Chair make the Report to the House of Commons and that Lord Lawson of Blaby make the Report to the House of Lords.

Ordered, That embargoed copies of the Report be made available (Standing Order No. 134 of the House of Commons).

[Adjourned till a time and date to be determined by the Chair.]

Witnesses

Witnesses who have given evidence to Sub-Committee B – Panel on HBOS are listed below.

Tuesday 30 October 2012

Page

Paul Moore, Head of Group Regulatory Risk, 2003– 2004, HBOS

B Ev w 1

Colin Matthew, CEO International, 2005– 2008, HBOS

B Ev w 12

Jo Dawson, Group Risk Director, 2005– 2006 and Group Executive Director Insurance & Investment Division 2006– 2008, HBOS

B Ev w 22

Monday 12 November 2012

Mike Ellis, Finance Director, 2001– 2004 and 2007–2008, HBOS,

B Ev w 31

Phil Hodgkinson, Finance Director, 2005– 2006, HBOS

B Ev w41

Peter Hickman, Group Risk Director, 2007– 2008. HBOS

B Ev w 51

Friday 16 November 2012

Lindsay Mackay, CEO Treasury, 2006– 2008, HBOS

B Ev w 60

George Mitchell, CEO Corporate, 2001– 2006 and CEO Treasury, 2004– 2006

B Ev w 69

Monday 19 November 2012

Sir Charles Dunstone, Chair of Retail Risk Committee, 2006– 2008, HBOS

B Ev w 83

Sir Ron Garrick, Deputy Chairman, SID and Chair of Corporate Risk Committee, 2006– 2008, HBOS

B Ev w 93

Tuesday 20 November 2012

B Ev w 104

Anthony Hobson, Chair of Audit Committee, 2001– 2008, HBOS

Friday 23 November 2012

Michael Foot, Managing Director, Deposit Takers & Markets Directorate, 1998– 2004, Financial Services Authority,

B Ev w 115

David Strachan, Director, Major Retail Groups, 2006– 2008, Financial Services Authority, and **Clive Briault**, Managing Director, Retail Markets, 2004– 2008 Financial Services Authority

B Ev w 123

Tuesday 27 November 2012

Peter Cummings, CEO Corporate, 2005– 2008, HBOS

B Ev w 135

Friday 30 November 2012

Financial Services Authority official

B Ev w 157

Witnesses who have given evidence to the main Commission in relation to the inquiry on HBOS are listed below. Transcripts of this oral evidence are available at www.parliament.uk/bankingstandards.

Monday 3 December 2012

Sir James Crosby, CEO, HBOS, 2001–2006, and **Andy Hornby**, CEO, 2006–2008 and CEO Retail and Chief Operating Officer, 2001–2006, HBOS

Tuesday 4 December 2012

Lord Stevenson, Chairman, 2001–2008, HBOS

List of published written evidence

Written Statements

1	Guy Bainbridge, Auditor, KPMG	B Ev w 170
2	Clive Briault, Managing Director, Retail Markets, 2004– 2008, FSA	B Ev w 174
3	Sir James Crosby, CEO, 2001– 2006, HBOS	B Ev w 180
4	Jo Dawson, Group Risk Director, 2005– 2006 and Group Executive Director Insurance & Investment Division, 2006– 2008, HBOS	B Ev w 186
5	Sir Charles Dunstone, Chair of Retail Risk Committee, 2006– 2008, HBOS	B Ev w 197
6	Mike Ellis, Finance Director, 2001– 2004 and 2007– 2008, HBOS	B Ev w 200
7	Michael Foot, Managing Director, Deposit Takers & Markets Directorate, 1998– 2004, FSA	B Ev w 207
8	Sir Ron Garrick, Deputy Chairman, SID and Chair of Corporate Risk Committee, 2006– 2008, HBOS	B Ev w 210
9	Peter Hickman, Group Risk Director, 2007– 2008, HBOS	B Ev w 217
10	Anthony Hobson, Chair of Audit Committee, 2001– 2008, HBOS	B Ev w 223
11	Phil Hodgkinson, Finance Director, 2005– 2006, HBOS	B Ev w 227
12	Paul Moore, Head of Group Regulatory Risk, 2003-2004, HBOS	B Ev w 251
13	Andy Hornby, CEO, 2006– 2008 and CEO Retail and Chief Operating Officer, 2001– 2006, HBOS	B Ev w 233
14	Lindsay Mackay, CEO Treasury, 2006– 2008, HBOS	B Ev w 239
15	Colin Matthew, CEO International, 2005– 2008, HBOS	B Ev w 244, B Ev w 247
16	George Mitchell, CEO Corporate, 2001– 2006 and CEO Treasury, 2004– 2006, HBOS	B Ev w 249
17	Richard Powell, formerly of the Bank of England	B Ev w 252
18	Lord Stevenson, Chairman, 2001– 2008, HBOS	B Ev w 254, B Ev w 257
19	David Strachan, Director, Major Retail Groups, 2006– 2008, FSA	B Ev w 265
20	Financial Services Authority official	B Ev w 268

HBOS Executive Committee Minutes

21	7 May 2002	B Ev w 274
22	20 January 2004	B Ev w 279
23	17 May 2005	B Ev w 285
24	5 – 6 June 2006 (away-day)	B Ev w 292
25	17 October 2006	B Ev w 304
26	31 October – 1 November 2006 (away-day)	B Ev w 311
27	14 September 2007	B Ev w 321
28	18 September 2007	B Ev w 323
29	23 October 2007	B Ev w 328
30	25 – 26 October 2007 (away-day)	B Ev w 332
31	22 April 2008	B Ev w 340

HBOS Board Minutes

32	26 November 2002	B Ev w 345
33	24 June 2003	B Ev w 352

34	28 October 2003	B Ev w 356
35	27 January 2004	B Ev w 360
36	24 February 2004	B Ev w 367
37	23 March 2004	B Ev w 375
38	18 May 2004	B Ev w 380
39	22 June 2004	B Ev w 386
40	27 July 2004	B Ev w 392
41	1 March 2005	B Ev w 397
42	24 May 2005	B Ev w 404
43	25 July 2006	B Ev w 409
44	22 May 2007	B Ev w 415
45	30 October 2007	B Ev w 420
46	1 April 2008	B Ev w 425
47	28 May 2008	B Ev w 430

Approved corporate facilities

48	Corporate banking advances over £20 million, September 2002	B Ev w 437
49	Corporate facilities over £75 million, September 2005	B Ev w 442
50	Corporate facilities over £75 million, September 2008	B Ev w 446

FSA documentation and regulatory correspondence

51	Letter from the FSA to James Crosby dated 24 December 2002	B Ev w 449
52	Letter from James Crosby to the FSA dated 12 March 2003	B Ev w 469
53	Letter from the FSA to George Mitchell dated 11 December 2003	B Ev w 469
54	Letter from George Mitchell to the FSA dated 9 January 2004	B Ev w 471
55	Letter from the FSA to James Crosby dated 13 January 2004	B Ev w 475
56	MRDG ARROW Panel minutes 8 December 2004	B Ev w 489
57	Letter from the FSA to James Crosby dated 21 December 2004	B Ev w 492
58	Letter from the FSA to Andy Hornby dated 29 June 2006	B Ev w 514
59	Letter from Lord Stevenson to the FSA dated 26 June 2007	B Ev w 525
60	Evaluation of progress against ARROW assessment dated October 2007	B Ev w 526
61	Email from Lord Stevenson to Sir Callum McCarthy dated 13 November 2007	B Ev w 530
62	Letter from the FSA to Andy Hornby dated 21 December 2007	B Ev w 531
63	Letter from Lord Stevenson to Sir Callum McCarthy dated 18 March 2008	B Ev w 534
64	Draft letter re. HBOS ARROW risk assessment dated March 2008	B Ev w 535
65	Letter from the FSA to Andy Hornby dated 22 April 2008	B Ev w 535
66	Letter from Andy Hornby to the FSA dated 1 August 2008	B Ev w 557
67	Letter from the FSA to Peter Cummings dated 17 October 2008	B Ev w 557
68	Financial Services Authority's Risk Mitigation Programme H2 2008	B Ev w 560
69	Peter Cummings, CEO Corporate, HBOS, 2006-2008 representations to the Regulatory Decisions Committee	B Ev w 571

The following evidence is available at www.parliament.uk/bankingstandards.

HBOS Group Business Plans and other reports

- 70 Five Year Funding Plan 2003
- 71 Funding the Business Plan 2004 – 2008
- 72 HBOS Group Business Plan 2002 – 2006
- 73 HBOS Group Business Plan 2003 – 2007
- 74 HBOS Group Business Plan 2005 – 2009
- 75 HBOS Group Business Plan 2006 – 2010
- 76 HBOS Group Business Plan 2008 – 2012
- 77 PwC Report on s.166