



BANK OF ENGLAND  
PRUDENTIAL REGULATION  
AUTHORITY



# The failure of HBOS plc (HBOS)

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

## Part 1

# Executive summary and recommendations

# 1

## 1.1 Why did HBOS fail?

1. On 1 October 2008 HBOS was approaching a point at which it was no longer able to meet its liabilities as they fell due and so sought Emergency Liquidity Assistance (ELA) from the Bank of England.<sup>(1)</sup> While the failure of the Group was directly triggered by a lack of liquidity, in large part this reflected underlying concerns about the solvency of the firm – concerns that turned out to be justified.
2. The failure of HBOS can ultimately be explained by a combination of factors:
  - Its Board failed to instil a culture within the firm that balanced risk and return appropriately, and lacked sufficient experience and knowledge of banking.
  - The result was a flawed and unbalanced strategy and a business model with inherent vulnerabilities arising from an excessive focus on market share, asset growth and short-term profitability.
  - This approach permitted the firm's executive management to pursue rapid and uncontrolled growth of the Group's balance sheet, and led to an over-exposure to highly cyclical commercial real estate (CRE) at the peak of the economic cycle, lower quality lending, sizable exposures to entrepreneurs, increased leverage, and high and increasing reliance on wholesale funding. The risks involved were either not identified or, where identified, not fully understood by the firm.
  - There was a failure by the Board and control functions to challenge effectively executive management in pursuing this course or to ensure adequate mitigating actions.
  - HBOS's underlying balance sheet weaknesses made the Group extremely vulnerable to market shocks and ultimately failure as the crisis of the financial system intensified.
  - There was an extended period of inflows of capital to developed economies, resulting in low yields, declining awareness of risk and asset price bubbles, in which market discipline – investors, analysts, rating agencies and other third parties – failed to constrain firms from undertaking risky strategies.
  - An overall systemic crisis in which the banks in worse relative positions were extremely vulnerable to failure. HBOS was one such bank.
3. Ultimate responsibility for the failure of HBOS rests with its Board. However, another striking feature of HBOS's failure is how the FSA did not appreciate the full extent of the risks HBOS was running and did not take sufficient steps to intervene before it was too late.
4. The FSA Board and executive management failed to ensure that adequate resources were devoted to the supervision of large systemically important firms such as HBOS. This gave rise to:

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

- a risk assessment process that was too reactive, with inadequate consideration of strategic and business model related risks;
  - insufficient focus on the core prudential risk areas of asset quality and liquidity in a benign economic outlook; and
  - too much trust being placed in the competence and capabilities of firms' senior management and control functions, with insufficient testing and challenge by the FSA.
5. The remainder of Part 1:
- outlines the history of the HBOS Group and the external economic environment in which it operated (Section 1.2);
  - summarises the Review's assessment of:
    - HBOS's strategy (Section 1.3);
    - how HBOS failed, with particular focus on asset quality, reliance on wholesale funding and capital (Section 1.4);
    - the management, governance and culture of the HBOS Group (section 1.5);
    - the FSA's regulatory approach (Section 1.6); and
  - makes recommendations arising from this Review (Section 1.7).

# 1

## 1.2 Background

### 1.2.1 The HBOS Group

6. The merger of the Halifax and Bank of Scotland in 2001 brought together a large former building society that had an extensive UK retail banking and insurance customer base, with a medium-sized bank that specialised in business banking and had a significant share of the Scottish corporate and retail banking markets.
7. A number of envisaged key benefits were cited at the outset of the merger. Increased market and product penetration opportunities, and an increased financial strength and deposit base were intended to enable the new firm to become one of the major UK banking groups and to challenge the existing 'Big 4'. The merger was also intended to partly address Bank of Scotland's limited customer deposits and consequent heavy reliance on wholesale markets to fund its lending business.
8. HBOS benefited from some synergies arising from the merger integration and the largely benign UK macroeconomic environment during the first half of the 2000s, and its profitability grew strongly. In the years leading up to the Review Period, HBOS pursued rapid growth across its retail and corporate lending businesses, while using its larger balance sheet to do increasingly large deals.
9. At the beginning of the Review Period, HBOS operated through five divisions:
  - Retail Division was the biggest part of the Group and was dominated by mortgage lending, which made up 92% of the division's loans and advances. HBOS was the largest mortgage lender in the UK throughout most of the Review Period, holding approximately a 20% market share.
  - Corporate Division mainly lent to UK businesses, with a significant share of the relationship banking market in Scotland (around 37%) and a much smaller one in England and Wales (3%). It focused on commercial property lending (where it and RBS were the two largest UK lenders to the market) and other property-related businesses such as construction, hotels and renting, while also lending to sectors such as manufacturing and transport.
  - International Division was a collection of insurance and banking businesses that had little in common, other than that they were not based in the UK. Parts of the International Division grew very rapidly during the period, particularly the Australian and Irish businesses, but overall it remained the smallest part of the Group (by assets) throughout.
  - Treasury Division managed funding and liquidity for the Group but also acted as a profit centre, carrying out a small amount of proprietary trading.
  - Insurance and Investment Division<sup>(2)</sup> was responsible for underwriting and administration of the insurance business, both life and general, within the Group.

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

## 1.2.2 External economic environment

1

10. Halifax and Bank of Scotland merged during a period of heightened corporate activity, in the middle of an economic cycle that had begun in the early 1990s. UK domestic economic growth had been relatively steady since the recession of the early 1990s, resulting in an extraordinarily long period (around 60 quarters) of continuous expansion. The growth in the financial services sector was more than twice as fast as the economy as a whole, averaging 6% per annum in the decade preceding the crisis, and increasing its share of nominal gross domestic product (GDP) to around 10%. Confidence in the future prospects of the economy was reflected in both bank and non-bank equity prices, which rose steadily from the start of 2003 until 2007.
11. As the benign conditions persisted for longer and longer, many perceived that a new paradigm of economic stability had been established. Commentators underestimated the risks that were building up in advanced economies as low interest rates and cheap – often cross-border – funding flattered banks' performance, and complex innovation increased the interconnectedness of financial firms.
12. The financial and economic trends in the run up to the crisis were unsustainable. Some of the incipient risks were identified and highlighted by central banks, regulators and other analysts but many of the trends had been evident for many years, in some cases decades, without risks crystallising in developed economies. Few predicted the severity and longevity of the crisis that was to occur.

## 1.3 HBOS's strategy during the Review Period

13. During the early part of the Review Period, HBOS pursued lending and treasury investment strategies which led to an increase in the risk profile of the Group, and made it increasingly vulnerable to an economic downturn.
14. HBOS's strategy focused primarily on revenue growth combined with strong cost control. It was simple and seemed compelling to many, both within and outside the Group, and for a period was partly fuelled by benefits from the merger. However, this strategy remained broadly unchanged from the merger and through the Review Period, despite the increase in risk in the external environment.
15. HBOS's strategy was articulated within its annual business plans. Certain features of the strategy were broadly consistent throughout the Review Period, including:
  - a return on equity goal of around 20%;
  - aggressive growth targets;
  - gaining a market share of 15-20% in all the key markets in which it was involved (the starting position differed between business lines); and
  - tight cost control, which was viewed as a competitive advantage.
16. What the strategy lacked was a clear articulation of the risks faced by the firm and its risk appetite in pursuing its objectives. As such, there were no effective risk-based measures that would constrain asset growth and prevent the strategy from becoming unbalanced and disconnected from the firm's funding and liquidity positions.
17. The Group put itself under pressure to maintain an increasing level of income. As margins declined on all forms of lending, a search for yield pushed it towards more risky propositions. Each of the lending divisions experienced an increase in its risk profile as it sought to grow income levels. Retail expanded its share of more risky specialist lending segments. Corporate increased its leveraged loans business and both Corporate and International generally increased the size and complexity of their deals, while also expanding their property lending, much of which was secondary and tertiary property. The decision to expand growth in HBOS's international operations was intended to provide diversification. In practice, it increased HBOS's overall exposure to high-risk commercial property. The Board failed to identify the extent to which HBOS was moving up the risk curve.
18. The Group sought to reduce reliance on interest income, but only made substantial progress in Corporate. A significant part of non-interest income in this division arose from taking equity stakes in businesses which were then sold down. This was a risky strategy as it created a reliance on a form of income that was cyclical and not sustainable in a downturn.
19. Key strategic decisions were taken by the Board which aggravated rather than improved the overall risk profile. An expectation of an increasingly difficult UK retail environment in 2007 led to a decision to rely more heavily on revenue from the Corporate Division, increasing the firm's exposure to riskier sectors and market segments, at what is now known to have been the peak of

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

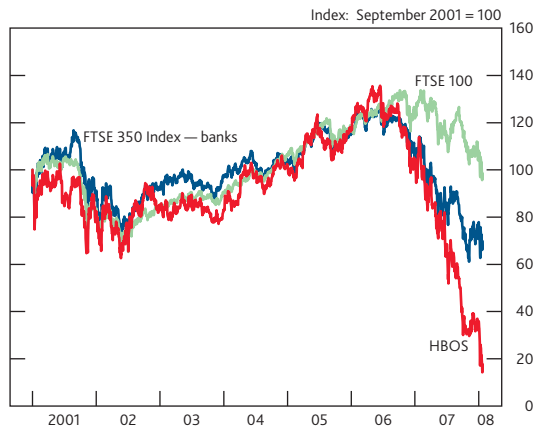
20. Following the onset of the crisis, the perception that HBOS had a highly risky strategy exposed to the UK property market was an important factor in its deteriorating external reputation.
21. HBOS's business model and strategy during the Review Period are considered in more detail in Part 2, Section 2.3.3, '*HBOS's strategy and business plans: 2004 to 2008*'. The role of the Board in formulating this strategy is discussed further in Section 1.5.2 below and in Part 3, Section 3.3.2, '*Key failings of the Group Board, Chairman and CEOs*'.



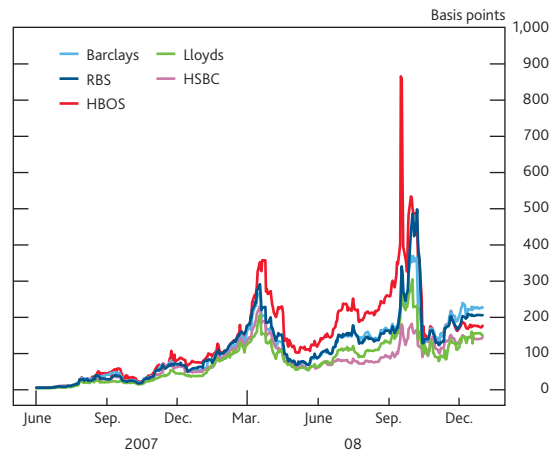
## 1.4 How HBOS failed

### 1.4.1 The final year

22. During 2007, vulnerabilities in the global financial system which had arisen during the long period of relative economic stability became increasingly apparent. Key vulnerabilities included:
  - low real interest rates resulting in a search for yield and investment in riskier (and often more complex and opaque) financial products with higher nominal returns;
  - increasing dependence by many banks on wholesale financial markets for funding and the growth of a shadow banking sector;
  - unsustainable rises in commercial and retail property prices; and
  - increasing leverage and indebtedness in the corporate, household and financial sectors.
23. Strains that had manifested themselves first in the US sub-prime mortgage market started to spread through global financial markets, impairing interbank liquidity internationally and in the United Kingdom. The impact of this spread further during summer 2007 when two Bear Stearns hedge funds effectively collapsed in July, shortly followed by the suspension of withdrawals from three investment funds managed by BNP Paribas. There was a significant reduction of global interbank liquidity as investors grew concerned about counterparties' exposures to bad debts and each other, and liquidity risks flowed back from the shadow banking sector to the banks. In September 2007, Northern Rock – which was known for its aggressive business strategy – sought ELA from the Bank of England and experienced a retail run.
24. HBOS invoked its contingency funding plan in September 2007. The plan covered early warning indicators, management escalation and actions to be taken. HBOS had committed to provide funding to a special purpose vehicle (known as Grampian) if the latter could not continue to finance its assets by issuing commercial paper in the market. As a result of the market issues, this facility, supporting £18.6 billion of assets, began to drawdown from August 2007. However, the Group also attracted £7.9 billion of additional retail and corporate deposits in 2007 Q4 as investors moved assets out of riskier investments. At this stage, the firm assumed that the dislocation would be temporary.
25. From a lending perspective, HBOS recognised that it needed to reduce asset growth and took action to address this. The bulk of the proposed reduction was targeted at the International Division. It was decided that Corporate would continue to lend, with a particular emphasis on supporting its existing customers. This decision was influenced by concerns about damaging HBOS's franchise if Corporate stopped lending and by the firm's ethos of 'lending through the cycle'. However, lending continued at well above planned levels throughout 2007 in both Corporate and International, and loans were in many cases made to new customers, not just existing ones.

**Chart 1.1:** HBOS and other large UK banks' share prices<sup>(a)</sup>

(a) Source: Bloomberg.

**Chart 1.2:** Large UK banks' three-year CDS spreads on subordinated debt<sup>(a)</sup>

(a) Source: Bloomberg.

26. In the context of the growing crisis, banks perceived as weak became increasingly vulnerable to failure. Brokers' views of HBOS were mixed during 2007. While there were some who continued to regard HBOS very positively, others became more pessimistic due to concerns about an impending downturn, with a few being particularly vociferous on account of the nature of the business HBOS had built. Analysis of broker reports shows that 'buy' remained the principal recommendation throughout 2007. Despite this, by 12 December 2007, before the pre-close Trading Statement the following day, HBOS's share price was 26% down on the start of the year, underperforming the sector as a whole.
27. Information contained in HBOS's December 2007 pre-close Trading Statement and the more detailed 2007 Preliminary Results announcement made on 27 February 2008, appears to have taken the market by surprise and significantly eroded the market's confidence in HBOS. This included: disclosure of its debt securities portfolio of £81 billion, of which asset-backed securities (ABS) exposures accounted for £41.9 billion; and disclosure of Alt-A assets worth £7 billion. HBOS's share price fell by 13% in the week following the pre-close Trading Statement and 23% in the week of the Preliminary Results announcement and continued to fall sharply during 2008, as shown in Chart 1.1.
28. HBOS's position was further tested less than three weeks later. On 19 March 2008, a British bank – named by some as HBOS – was rumoured to be facing severe strain following the collapse of the US investment house Bear Stearns, allegedly prompting the Governor of the Bank of England to cancel travel plans. Both the FSA and the Bank of England refuted the rumours and HBOS's share price partially recovered its sharp intra-day falls. Against a backdrop of uncertain market conditions at the time, the incident highlighted HBOS's apparent vulnerability to market gossip. Around this time, HBOS's credit default swap (CDS) spreads spiked and widened relative to those of other large UK banks, as shown in Chart 1.2.
29. There was a gradual deterioration in the maturity profile of the firm's liabilities from this point as maturing long-term funding was replaced increasingly by short-dated instruments. It appears there was reluctance from HBOS to 'pay up' for longer term funding, even when it was available, to avoid the market interpreting this as a distress signal.
30. As its funding position continued to deteriorate, HBOS revised its plans. The firm took a number of short-term actions to address its vulnerable position, including seeking to grow its customer deposit base. Decisive action was finally taken to halt balance sheet growth. From a funding perspective, HBOS significantly increased its securitisation programme to access the Bank of

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

31. In addition, in April 2008 HBOS announced that it would raise £4 billion of capital via a rights issue, with the stated objectives of: rebasing the Group to stronger capital ratios; consolidating the Group's strengths in its core markets; mitigating the increased volatility of the Group's regulatory capital under Basel II; and covering the fall in market value of the Treasury portfolio.
32. These actions did little, however, to alleviate market participants' concerns regarding the sustainability of the Group's business model, and in particular its exposures to the UK property market and reliance on wholesale funding. A further deterioration in market sentiment towards the banking sector generally, as well as HBOS specifically, resulted in a subscription rate to the rights issue of just 8.29%, with underwriters left to take up the remaining proportion of shares. By end-July 2008, HBOS's share price had lost 60% of its value at the beginning of the year and its CDS spreads were increasingly wider than those of other large UK banks.
33. On 15 September 2008, Lehman Brothers failed, disproving the market's belief that certain institutions were 'too big to fail'. The result was a significant dislocation to financial markets and further reduction in interbank liquidity, aggravating funding conditions for all banks. HBOS, however, with its massive wholesale funding requirement, was particularly affected and was largely only able to secure funding on an overnight basis.
34. By the time that Lehman Brothers collapsed, HBOS had no real funding options left, having already used a significant proportion of its collateral eligible for central bank funding schemes. In the following days, it came under acute and sustained funding pressure, including receiving – and in some cases acceding to – requests to buy back debt instruments before maturity.
35. Furthermore, HBOS began to see material outflows of customer deposits. The Irish and Australian businesses were also experiencing customer withdrawals and so required additional funding from the United Kingdom to meet local regulatory requirements. As a result of these factors, HBOS faced an additional, unexpected funding need of £12.5 billion in the week after Lehman Brothers failed.
36. On 17 September 2008, two days after the collapse of Lehman Brothers, HBOS publicly confirmed it was in discussion with Lloyds TSB concerning its takeover, with the takeover announced on 18 September 2008. It is debatable what impact this announcement had on HBOS's funding position. While there was clear market relief immediately after the takeover announcement, the short-to-medium term consensus was negative. There was a view among HBOS management at the time that some institutions reduced their individual lending limits to the two banks to a lower combined limit (with the reduction biting for HBOS not Lloyds TSB), thus reducing HBOS's borrowing capacity.
37. Overall, the firm's liquidity position deteriorated dramatically in the second half of September 2008. Further deposit outflows resulted in an additional £2 billion funding need over the last week of September, and increasing volumes of overnight funding meant that daily wholesale maturities were between £15 billion and £20 billion. On 1 October 2008, HBOS was approaching a point at which it was no longer able to meet its liabilities as they fell due. The firm had exhausted its eligible collateral for use in the SLS and so sought ELA from the Bank of England.
38. Further details regarding HBOS's final year can be found in Part 2: Section 2.8.5, '*Key events and triggers: what were the events which triggered the liquidity crisis leading to the firm's failure?*'; and Section 2.10, '*Shifting market perceptions of HBOS*'.

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

## 1.4.2 Asset quality

40. A key feature of HBOS's balance sheet was its concentration in property, particularly commercial property. HBOS saw real estate lending not just as a core competence but as 'safe' lending. As such, each division was heavily exposed to property and property-related sectors. This was well known to the market. During the Review Period, exposure to property and property-related interests accounted for around 75% to 80% of all loans and advances to customers. A concentrated exposure of this magnitude to any sector carries risks, but it should be possible for such risks to be managed effectively. In this case, however, the risk to HBOS's long-term sustainability was heightened by a considerable proportion of its exposures being to the highly cyclical CRE sector. By the end of the Review Period, £76 billion of the Corporate Division's portfolio was exposed to commercial property or related sectors. In addition, approximately £12 billion of the International Division's Irish portfolio and £6 billion of its Australian portfolio was exposed to commercial property or related sectors.
41. A second key feature was its lower quality lending. The Corporate Division actively targeted 'sub-investment grade' borrowers. The International Division's weak credit assessments led the businesses to take on lower-quality exposures than was appreciated. Both Corporate and International pursued opportunities to hold riskier, junior debt and to provide equity to borrowers. Meanwhile, the Retail Division was one of the largest lenders in the United Kingdom of higher risk self-certified mortgages, while it moved up the risk curve to maintain buy-to-let (BTL) market share.
42. A third key feature was its significant support of entrepreneurs in their pursuit of different business ventures. This was a characteristic of both Corporate and International (in particular, Ireland) and it led to sizeable single-name exposures. At the end of 2005 the Corporate Division's top 30 exposures represented 15% (£19.2 billion) of the division's portfolio. By the end of September 2008, the top 30 exposures represented 21% of the division's portfolio (£30.9 billion). The largest of these exposures was £1.8 billion and there were fourteen exposures in excess of £1 billion.
43. A fourth key feature was its rapid expansion. Total Group assets grew from £477 billion in 2004 to £690 billion in 2008, giving a compound annual growth rate of 10% during the period (Table 1.1). Moreover, the Group rapidly grew its higher risk assets, such as CRE, at the top of the economic cycle at a time when there was downward pressure on margins and lending terms, including high leverage and weak covenants.
44. In 2007, the Corporate and International Divisions grew loans and advances by 22% and 38%<sup>(3)</sup> respectively, as the firm sought to increase revenues in these areas partly to compensate for the decline in the Group's traditional mainstream retail mortgage lending.
45. In the Corporate Division, although the volumes of new loans sanctioned after August 2007 were not as high as the volumes of new loans sanctioned in the first seven months of the year, the division's exposures continued to grow strongly to the end of 2007. As well as new lending,

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

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

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

**Table 1.1: HBOS total assets and growth by division 2004-2008 (as at 31 December)<sup>(a)</sup>**

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

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

47. A final aspect was that Treasury invested in ABS as a significant part of its liquidity portfolio on the assumption that these assets could be sold or used as collateral to raise secured funding in a liquidity stress. As the stress that developed from 2007 onwards involved a lack of confidence in the assets that backed these securities and then the securities themselves, this assumption proved to be wrong.
48. HBOS's approach was not unique in all respects. Most of the leading UK banks during the period had high return targets and had grown significantly, while some also had significant exposures to commercial property. However, the combination of all of these factors, when also combined with HBOS's exposures to highly leveraged businesses, single names and riskier junior debt/equity, led to HBOS being particularly vulnerable to an economic downturn.
49. Further details regarding the asset quality of the different divisions can be found in Part 2: Section 2.4, '*Asset quality – Corporate Division*'; Section 2.5, '*Asset quality – International Division*'; Section 2.6, '*Asset quality – Retail Division*'; and Section 2.7, '*Asset quality – Treasury Division*'.

### Impairment losses – a consequence of poor asset quality

50. In the three-year period from 2005 to 2007, the annual impairment losses recognised in the HBOS Group's income statement<sup>(4)</sup> ranged between £1.7 billion and £2.1 billion. The losses on the Group's lending portfolios increased markedly from September 2008 onwards, with impairment losses of £13.5 billion being ultimately recognised for the 2008 year-end.
51. Within Corporate, despite the deteriorating economic outlook in 2008, the business functions were reluctant to accept that the loans were going bad, and were reluctant to re-categorise and

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

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

52. The optimism also meant that throughout 2008 the division proposed levels of provisions which did not reflect the declining market conditions, and were increased following intensive discussions with the firm's external auditors. Even then, the firm consistently chose the level of Corporate provisions at the least prudent end of the range deemed acceptable by its external auditors, though the approach had changed by the time that the 2008 year-end impairment figures were finalised in early 2009.
53. In its Annual Report and Accounts for the year ending 31 December 2007 (published early 2008) HBOS reported a profit before tax of £5.5 billion. The Annual Report and Accounts for 2008 (published early 2009) showed a loss of £11 billion. In its half-year interim results for the year to June 2008 (published 31 July 2008), the charge for Group impairment losses was £1.3 billion; yet by year-end 2008 this figure had risen to £12 billion. The deterioration in the quality of HBOS's loan book and the speed with which it all happened, are a notable part of the HBOS story. Section 2.11, '*HBOS financial reporting*', in Part 2 of this Report draws extensively on the published annual reports and accounts and the various interim financial statements issued by HBOS in relation to the Review Period. It also draws heavily on the audits and other reviews and reports which were presented to HBOS Board and senior management by KPMG.<sup>(5)</sup> This material is included to show how the losses emerged over time, what information was available to HBOS's Board and senior management, what warnings were given to HBOS's Board and senior management, what decisions were taken as a result, and how these losses were recognised in the published financial statements. It is not within the Terms of Reference for this Review to opine on the content of the annual reports and accounts or the various interim financial statements which HBOS issued throughout the Review Period. Similarly, it is not within the Terms of Reference for this review to opine on whether the formal audits, reviews or other work undertaken by KPMG in relation to HBOS met the required standards – these are matters for the Financial Reporting Council (FRC). With that in mind, in the course of the Review the PRA and FCA remained in regular contact with the FRC and wrote to the FRC inviting it to consider whether there were grounds to investigate KPMG and/or senior KPMG people in relation to the audits of HBOS's financial statements for 2007 and 2008 and, by extension, HBOS senior management. The FRC carried out a review into these matters and advised that the criteria for commencing an investigation were not met. The FRC has indicated that it will consider any relevant new information contained in the HBOS Report once finalised and published.
54. From the end of the Review Period in 2008 until 2011, HBOS recognised a total of £52.6 billion of impairment losses in its income statement: £44.7 billion were referable to the Group's lending portfolios, with the remainder from its securities holdings.
55. Table 1.2 shows the recognised impairment losses of the Group on its loans and debt securities split by division. By far the worst-performing divisions were Corporate and International, with £21.9 billion and £15.5 billion of impairments, equivalent to a fifth and a quarter of total loans and advances at end 2008 respectively. Within these divisions, losses were predominantly incurred on their commercial property portfolios. While in mid-2008 the market was expecting HBOS to incur losses, the magnitude of the losses was not predicted. The impact of the crisis on HBOS's Retail book was less severe than its impact on the Corporate and International books.

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

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

**Table 1.2: HBOS Group recognised impairments in the income statement 2008 to 2011<sup>(a),(b)</sup>**

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

(a) HBOS *Annual Reports and Accounts* 2008-2011. The Review Team has used its judgement to allocate losses to the HBOS divisions, as following LBG's acquisition, the HBOS divisional structure was dissolved.

(b) The impairments for Retail, Corporate and International are impairment losses on loans and advances. The impairments for Treasury are impairment losses on debt securities. Other impairments are those that the Review has been unable to allocate to a division, as well as 2008 impairments on Corporate's debt securities. Part 2, Section 2.3.6 and Appendix 4, PCBS question 1 set out in more detail why it has not been possible to allocate all impairments to a particular division.

(c) Gross loans and advances, except for the Treasury Division which includes £76.7 billion of debt securities.

57. The depth and length of the recession as a result of the crisis starting in 2007 undoubtedly contributed to a number of companies experiencing financial difficulties and going into administration. However, it was the policies and actions that HBOS pursued in the benign times prior to the crisis that determined the extent to which it was exposed to the downturn and how resilient it was. In this regard, the policies and actions created a business model that was highly cyclical and amplified the effects of the recession leading to significant losses.
58. HBOS's losses are considered further at the end of each section on asset quality in Part 2 referred to above, and also in the response to Question 1 of the *'Questions from the Parliamentary Commission on Banking Standards'* at Appendix 4.

### 1.4.3 Underlying balance sheet vulnerabilities

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

#### Reliance on wholesale funding

60. By the end of September 2008, HBOS was no longer able to meet its needs from the wholesale market and was facing a withdrawal of customer deposits. On 1 October 2008, the Bank of England provided HBOS with ELA so that the firm would be able to continue to meet its liabilities as they fell due.
61. The rapid expansion of its balance sheet placed pressure on HBOS's ability to fund itself. HBOS's retail funding struggled to keep pace with the Group's lending growth, with customer deposits growing at an average annual rate of 5% a year during the Review Period, compared with a customer loan growth rate of 10%. As a result, HBOS increasingly accessed wholesale financial

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

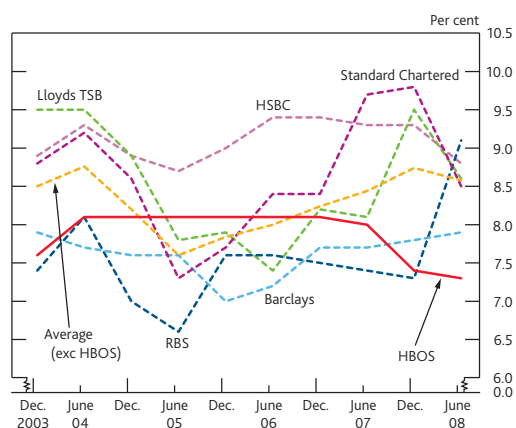
62. The disparity between the amount HBOS lent to its customers and the amount it held in customer deposits was further highlighted by HBOS's loan-to-deposit ratio, which increased from 143% at the time of the merger to 170% at the end of 2007. While this was below the Bank of Scotland level of 194% immediately before the merger, it was well above the ratios of HBOS's clearing bank competitors and at the top of the range for UK mortgage banks, with the exception of Northern Rock which failed. By the end of 2008, HBOS's loan-to-deposit ratio had reached 192%.
63. The management and Board of HBOS recognised that an over reliance on wholesale funding was a weakness but this was never tackled as a key risk to the stability of the business. Instead, the possible need for additional funding was viewed as a risk to further asset growth, and was considered mainly in those terms. So, for example, higher levels of customer deposits were seen as a way of increasing lending capacity rather than reducing liquidity risk.
64. As early as 2004, the HBOS Board took steps to lengthen the tenor of its wholesale funding and diversify the sources of wholesale funding. As a result, the percentage of HBOS's funding with a maturity of over one year increased from 33.5% at end-2003 to a peak of 47.5% at end-2006.
65. Nevertheless, the absolute size of its funding requirement meant that HBOS still had large volumes of short-term funding with tenors of one and three months (at their peak in March 2008 of approximately £64 billion and £61 billion respectively).<sup>(7)</sup>
66. In addition, the structure of HBOS's funding requirement made it particularly vulnerable to closure of wholesale funding markets. As the largest participant in the UK residential mortgage-backed securities (RMBS) market from 2003, HBOS was reliant on securitisation as a source of funding. When uncertainty grew regarding the credit quality of the assets underlying these securities from mid-2007, new business could no longer be securitised creating a need to find alternative funding. In addition, as referred to above, HBOS needed to provide funding to its special purpose vehicle, Grampian.
67. HBOS's own liquidity standard was significantly more stringent than the prevailing – albeit inadequate – regulatory standard of the time: the firm having set itself a requirement that it should hold sufficient liquidity to meet a one-month wholesale outflow. HBOS had grown its liquidity buffer from £84.4 billion in 2004 to £147.8 billion in 2008.
68. However, in 2004 the HBOS Board decided to change the composition of Treasury assets comprising its liquidity buffer from a majority of gilts to a majority of other, typically AAA-rated<sup>(8)</sup> ABS. This allowed Treasury to increase the yield on its assets, in effect becoming a profit centre by taking on higher-risk assets that it believed could be used to generate liquidity at a time of stress. At the time, ABS markets were deep and growing and there was an active repo market. However, this market was still relatively immature and had not been tested in a downturn.
69. The decision to invest in ABS assets that were not sufficiently distinct from the other assets of the firm further concentrated HBOS's balance sheet in property-related assets. These assets proved insufficiently liquid when financial market conditions worsened and then deteriorated further following the failure of Lehman Brothers.

(6) Defined for this purpose as the sum of 'deposits by banks' and 'debt securities in issue' as stated in the annual reports and accounts.

(7) That said, firms with different business models were running positions with much larger volumes of short-term funding – data submitted to the FSA indicates that other firms had to refinance one-week positions significantly greater than HBOS's one-month position.

(8) The standard definition of an AAA rating is that the issuer has extremely strong capacity to meet its financial commitments.



Chart 1.3: UK banks' published Tier 1 capital ratios<sup>(a)</sup>

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

70. The magnitude and structure of the firm's wholesale funding, the size of and need to finance Grampian, and the composition of HBOS's liquidity portfolio contributed to its eventual failure.
71. See Part 2, Section 2.8, '*Funding and liquidity*' for further details.

## Capital

72. The Group reported Tier 1 and Total Capital ratios of 8% and 12% respectively at 30 June 2007<sup>(9)</sup> which were significantly in excess of the regulatory minima and were firmly within the range of its peer group (Chart 1.3)<sup>(10)</sup>. There is no evidence that HBOS breached regulatory capital requirements during the Review Period and it was only from late 2007 that the firm's capital position started to look particularly weak compared to the other major UK banks.
73. Prior to 1 January 2008, the regulatory capital regime was Basel I and subsequently was Basel II. These regimes set a minimum standard and generally UK firms, including HBOS, held more capital than the minimum. A critical weakness of the regimes was that they did not require capital buffers to be built up in the good times to absorb losses in the bad.
74. While regulatory capital ratios remained stable and looked robust, leverage had increased for HBOS and the banking industry as a whole between 2005 and 2007. At the end of 2007, HBOS had £1 of shareholders' equity supporting every £30 of assets. If account is taken of the significant commitments (such as committed but undrawn facilities) which were not on the firm's balance sheet, the true leverage of the firm was significantly higher than 30:1. With a smaller proportion of capital supporting an ever growing balance sheet, the potential impact of a downturn on the firm had increased. For HBOS, poor analysis of risks and overly competitive pricing meant that risk and reward had become unbalanced, and these vulnerabilities elevated.
75. See Part 2, Section 2.9, '*Capital*' for further details.

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

(10) See also Part 2, Chart 2.67.

## 1.5 Management, governance and culture

1

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

### 1.5.1 Board composition and challenge to executive management

77. The composition, size and structure of the HBOS Board were typical for a large UK bank at the time. However, it failed to provide effective challenge to the firm's executive management. Lord Dennis Stevenson of Coddenham was HBOS Group Chairman throughout the Review Period and had overall responsibility for leadership of the Board, setting the agenda and ensuring its effectiveness.
78. As a group, the non-executive directors (NEDs) on the Board lacked sufficient experience and knowledge of banking. Of the twelve NEDs who served on the Board during the Review Period, only one had a background in banking and he was appointed in May 2007. The NEDs were all people who had achieved a high degree of success in their own fields and had significant experience of serving on corporate boards. However, this lack of experience and knowledge of banking hindered the NEDs' ability to provide effective challenge to executive management. As a result, risk was given insufficient time, attention, focus and priority by the Board. Indeed, the Review found a lack of contemporaneous evidence of debate and challenge at Board meetings around key areas of risk faced by the Group, including:
- the Group's continued over-reliance on wholesale funding;
  - the risks associated with the firm's rapid growth and philosophy of 'lending through the cycle', in particular the ability of internal controls to keep pace with this growth;
  - the Corporate Division's claims that it had unique expertise in commercial property and a significant competitive advantage over its peers with its integrated finance business;
  - the risks taken by the Corporate Division in the course of exceeding its lending targets in 2006 and 2007; and
  - the replication of strategies used in the UK by the International Division in Ireland and Australia.
79. A recurrent theme in Board evaluations was a desire that the Chairman should promote more open discussion in Board meetings. Although directors told the Review that many points were raised in bilateral discussions outside Board meetings, these can be no substitute for an effective board process which enables NEDs as a group to challenge management.

80. The lack of experience and knowledge of banking amongst the NEDs was compounded by similar lack of banking experience within the executive management team. In particular, both of the Group Chief Executive Officers (CEOs) during the Review Period had limited banking experience and only Mr Peter Cummings and Mr Colin Matthew (the Chief Executives of the Corporate and International Divisions respectively) had experience of corporate banking. As a result, the Board was heavily reliant on Mr Cummings and Mr Matthew to oversee the firm's corporate banking businesses.
81. Further details regarding the Board can be found in Part 3: Section 3.2, '*Design of the management and governance arrangements*' and Section 3.3, '*Management and governance failings in practice*'.

### 1.5.2 Formation of strategy and risk appetite

82. One of the key factors in the demise of HBOS was the failure to establish an appropriate strategy for the Group, set in the context of clearly identified risks and measures to quantify and control risk. Approving the strategy, which was developed by the CEO and Group Finance Director in consultation with the Chairman, was the responsibility of the Board. The Board, however, played a limited role in the development of the Group business strategy.
83. Mr James Crosby<sup>(11)</sup> (up to July 2006) and Mr Andy Hornby (from August 2006) were the Group CEOs during the Review Period, to whom the HBOS Board delegated responsibility for strategic planning.
84. A crucial weakness of HBOS's strategic approach was that it was developed and pursued in the absence of a clearly defined risk appetite statement for the Group as a whole and the ability to aggregate risks at Group level. As a result, key risks such as HBOS's reliance on wholesale funding, were not adequately addressed by the strategies of each of the operating divisions. Further, HBOS used the annual divisional business planning process as the main mechanism for reviewing the Group's strategy. This meant that discussions about the firm's strategy and risk appetite tended to focus on performance targets.
85. The formulation of HBOS's strategy and risk appetite are considered further in Part 3, Section 3.3, '*Management and governance failings in practice*'.

### 1.5.3 Risk management framework

86. A key feature of HBOS's failure was that the internal controls within its operating divisions, in particular its Corporate and International Divisions, were ineffective and did not keep pace with the rapid growth that these divisions experienced. The FSA's Enforcement Final Notices issued to Bank of Scotland plc and Peter Cummings highlighted a number of core control issues relating to the Corporate Division, including:
- there was no process for defining risk appetite, beyond high-level industry sector limits, and these were not used effectively to constrain growth;
  - risk management was regarded as a constraint on the business rather than integral to it;
  - individual sanctioning decisions were made without a detailed consideration of the impact on the wider portfolio; and

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

- a significant part of the portfolio had not been risk-rated or ratings were out of date.
87. Within the International Division, the risks attached to rapid growth were consistently highlighted, but generally do not appear to have led to any significant restraint in the division's plans. Representations indicated a difference of view (which the Review was unable to resolve through contemporaneous documents) as to the respective roles and responsibilities of the division's UK-based and local operations, in particular with regard to the carrying out of credit sanctioning assessments.
  88. The impact of these deficiencies at divisional level was exacerbated by the ineffectiveness of the firm's Group control functions. The effectiveness of the firm's Group Risk function was hampered by personnel and structural changes. Challenge from Group Internal Audit was limited, with some evidence that internal audit reports could be upgraded based on promises from the business to make improvements. The Audit Committee and the Corporate and International divisional Risk Control Committees did not provide effective challenge on issues that were brought to their attention.
  89. The Board delegated responsibility for the firm's overall systems and controls to the Group CEO.
  90. HBOS's risk management framework is considered further in Part 3, Section 3.4, '*Failings in the implementation of the risk management framework*'.

#### 1.5.4 Risk culture

91. The ineffectiveness of HBOS's risk management framework was a consequence of a culture within the firm that prioritised growth aspirations over the consideration of risk. HBOS's weak risk culture was evident at all levels of the firm, with the Board-approved emphasis on growth setting the tone for the rest of the organisation.
92. The early success of HBOS in the benign economic conditions prior to the crisis also led to complacency during the crisis. For example, some members of the HBOS Board expressed confidence in the strength of the firm's balance sheet and viewed the economic downturn as an opportunity to grow, even though they were aware of weaknesses in the firm's credit risk management capability and its overreliance on wholesale funding.
93. HBOS's risk culture is considered further in Part 3, Section 3.3, '*Management and governance failings in practice*'.

## 1.6 FSA supervision

### 1.6.1 A deficient regulatory approach

94. Consistent with the findings of *The RBS Report*, the failings of the FSA in relation to HBOS were primarily due to deficiencies in the FSA's prevailing approach to the supervision of systemically important firms, which the FSA Board and Executive Committee (ExCo) did not adequately challenge or review.
95. FSA senior management<sup>(12)</sup> adopted an approach to supervision which entailed placing heavy reliance on a firm's senior management and control functions. The FSA did not see its role as being to criticise a firm's business model in case it was perceived to be acting as a 'shadow director'.
96. This approach gave rise to a supervisory framework with:
  - inadequate resources devoted to the prudential regulation of large systemically important banks;
  - inadequate focus on the core prudential risk areas of asset quality and liquidity in an apparently benign economic outlook;
  - inadequate consideration of strategic and business model related risks, including the adequacy of capital buffers; and
  - a risk-assessment process that was too reactive.
97. Despite the FSA's prudential responsibility for systemically important firms and as noted in *The RBS Report*, the FSA Board did not play any operational role in decisions relating to the supervision of specific firms. The Board did, though, receive briefings on current issues – including major firm-specific issues – from executive management and so was in a position to ask questions and challenge assumptions. However, no prudential issues were raised in relation to HBOS in the pre-crisis period in board reports.
98. Members of ExCo had very little proactive engagement with retail firms or their supervision teams, unless there was crystallised risk. Furthermore, in the pre-crisis period, while ExCo did have high-level discussions about resourcing and priorities, it neither had in-depth discussions, nor received detailed management information, about specific aspects of the operating model, such as the supervisory resource per firm or the balance of work between conduct and prudential issues.
99. Overall, the FSA's approach was too trusting of firms' management and insufficiently challenging. The FSA executive management, led by CEO Mr John Tiner, designed (or failed to redesign) this deficient approach to supervision. Further, the oversight of the executive by the FSA Board, led by the Chairman Sir Callum McCarthy<sup>(13)</sup>, was insufficient. As the Managing

(12) FSA 'senior management' refers to Head of Department level up to Managing Director.

(13) Callum McCarthy became Sir Callum McCarthy in June 2005 and is referred to throughout the Report as Sir Callum.

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

100. It is now clear that the FSA's pre-crisis<sup>(14)</sup> approach to prudential supervision was not appropriate for the purpose of meeting its market confidence objective. However, the FSA was responsible for a broad range of financial regulation issues and was expected to regulate within established global standards. There was also a sustained political emphasis on the need for the FSA to be 'light touch' in its approach and mindful of the United Kingdom's competitive position.
101. Within this context, it was inherently unlikely that senior leaders of the FSA would have proposed, before the first signs of the crisis (for example, before summer 2007), a supervisory approach which entailed higher capital and liquidity requirements, supervisory caps on rapid bank balance sheet growth, or intensive analysis of asset quality. If they had, it is likely that their proposals would have been met by extensive complaints that the FSA was pursuing a heavy-handed, gold plating approach which would harm the United Kingdom's competitiveness.
102. The FSA's regulatory approach is considered in more detail in Part 4, Section 4.2, '*The FSA's philosophy and approach to supervision*'.

## 1.6.2 Supervision of HBOS in the pre-crisis period

103. In the years prior to the crisis, the FSA had identified a number of key risks which ultimately contributed to the failure of HBOS. These included: the need for strong Group control functions to counterbalance the federal structure; the risks within the CRE book; the atypical credit approval processes in Corporate; a lack of technical expertise at a senior level in Group Risk; the significant reliance on wholesale funding; and that the control framework was not appropriate to support the rapid growth overseas.
104. The FSA's early focus on the adequacy of HBOS's risk management framework included the commissioning of an independent Skilled Persons Report by PwC in 2004. However, this early focus was not sustained with sufficient intensity throughout the Review Period, as priorities shifted and apparent progress was made by the firm to address the risks.
105. A core judgement made by the HBOS supervision team<sup>(15)</sup> from late 2005 was that HBOS's overall control framework was good and that the firm had an 'open and cooperative' relationship with the FSA. Indeed, the relationship was generally seen as better than the FSA had with most of HBOS's peers. This judgement, together with the benign economic outlook and resource constraints, had implications for the intensity with which HBOS was supervised, with much reliance being put on HBOS's senior management and control functions.
106. For a significant portion of the Review Period, Mr Crosby was both HBOS Chief Executive and a member of the FSA board. However, the Review found no evidence that Mr Crosby exercised any undue influence as a member of the FSA Board or its committees on the decisions of the FSA in relation to the supervision of HBOS.
107. The supervision team prioritised FSA priorities, such as Basel II implementation and the 'Treating Customers Fairly' (TCF) initiative, together with reactive work in areas where there was crystallised risk or high-profile conduct issues. It was not until after the failure of Northern Rock

<sup>(14)</sup> For the purposes of this Report, the failure of Northern Rock in September 2007 is defined as the start of the crisis period.

<sup>(15)</sup> The 'supervision team' refers throughout this report to the FSA team, led by a relationship manager, responsible for the supervision of HBOS.

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

108. While the resourcing level on the supervision team was broadly in line with the FSA's prevailing approach to a firm of this kind, the team experienced an unusually high volume of turnover, which included three changes of manager during the Review Period. This created a lack of continuity and made it more difficult for supervisors to identify patterns of behaviour and emerging risks over time.
109. Although the supervision team escalated key issues and judgements, FSA senior management were distant from day-to-day supervision. Senior management did not provide sufficiently clear direction to front-line supervisors, track progress or monitor issues over time. Further, consistent with the FSA's approach at the time, key interactions with HBOS were primarily led by the supervision team rather than at a more senior level. This undermined the FSA's credibility when challenging senior management and too much responsibility for identifying and mitigating problems was delegated to too junior a level.
110. A divisional initiative launched by Major Retail Groups Division (MRGD) senior management in late 2005 resulted in a number of items being removed from HBOS's Risk Mitigation Programme (RMP), which was the supervision team's only formal tracking framework of actions to address identified risks. The initiative was intended to make the best use of limited supervisory resource by ensuring supervision teams focused on those issues which were considered to pose the greatest risk to the FSA's objectives. While the supervision team continued to meet regularly with HBOS to discuss progress on these issues, the pace of remediation of issues appears to have slowed. This initiative also led to even greater reliance being placed on HBOS senior management and Group control functions to confirm that issues had been addressed, with limited testing carried out by the FSA.
111. The FSA was the consolidated regulatory authority for the HBOS Group. But it placed a considerable amount of reliance on local regulatory authorities, as well as the firm's Group Risk function, to provide oversight of HBOS's International businesses. This posed a challenge to effective supervision of the entire HBOS Group by the FSA and gave rise to a risk of underlap. In the case of HBOS's corporate lending business in Australia, it appears that there was a lack of clarity within the FSA supervision team as to the limits of the oversight provided by the Australian Prudential Regulatory Authority (APRA).
112. The supervision team suffered from a lack of continuity, experience and senior FSA management engagement. A more experienced, stable and better-supported supervision team might have been more sceptical about the effectiveness of the relationship with HBOS senior management given its knowledge of issues at the firm at the time. Had it been more sceptical, it might have taken a number of actions to address weaknesses in the pre-crisis period, including:
  - questioning the amount of reliance that could be placed on HBOS's control functions and undertaking a follow-up review on the effectiveness of risk management;
  - considering taking steps to restrict HBOS's asset growth, being aware of the firm's increasing reliance on wholesale funding;
  - following through effectively on concerns raised about the control framework in International;
  - pressing Corporate to take a more rigorous approach to the risk profile of its CRE exposures following a 2005 stress-testing exercise;
  - questioning whether the difficulties Corporate had with Basel II implementation were indicative of wider failings in risk management; and

- recognising the importance of HBOS having a board constitution that more strongly reflected the evolving business risk profile.
113. A more probing, sceptical and interventionist stance in the pre-crisis period could have delivered different outcomes but this would have required a significant increase in the resources and experience of the team, together with a different approach to supervision and the active support of FSA executive management and the Board.
114. The FSA's supervision of HBOS in the pre-crisis period is considered further in Part 4: Section 4.3, '*Prudential supervision of HBOS*'; Section 4.4, '*Supervisory approach to asset quality*'; Section 4.5, '*Supervisory approach to liquidity and Treasury asset quality*'; Section 4.6, '*Supervisory approach to capital and Basel II implementation*'; and Section 4.7, '*Supervisory approach to management, governance, culture and control functions*'.

### 1.6.3 Supervisory response to the deteriorating economic environment

115. The FSA took action quickly after the failure of Northern Rock, in September 2007, to review the position of the most vulnerable firms whose business models bore most similarity to that of Northern Rock. This marked the start of FSA contingency planning work.
116. Throughout the contingency planning period, in particular from March 2008, there was an unprecedented level of FSA senior management involvement in the supervision of HBOS, including by the FSA Chairman, Sir Callum, and Chief Executive, Sir Hector Sants.<sup>(16)</sup>
117. With greater support and direction from FSA senior management, the supervision team prioritised prudential issues following the onset of the crisis. In August 2007, HBOS was identified as one of a number of firms that were particularly vulnerable to market disruption. There was heightened supervisory focus on HBOS's funding and liquidity from this point. However, despite the fact that HBOS was a peer outlier in terms of its reliance on wholesale funding, the FSA did not focus on it as a bank with a prospect of failure until March 2008.
118. Greater action by the FSA, and HBOS, in the period from August 2007 to February 2008 could arguably have helped to reduce the cost of failure. However, the possibility that HBOS could fail was still seen as remote during this period. Within the context of what was seen at that time to be a temporary dislocation in the financial markets, HBOS appeared to be weathering the early storm reasonably well following steps taken in August and September 2007 to renew its wholesale funding.
119. Contingency planning work on HBOS intensified from March 2008 in response to a number of significant market events which led to a further tightening of liquidity in financial markets. This period also marked the start of activity by the Tripartite authorities on various generic bank measures, including the need for more capital and the provision of additional funding through the establishment of the SLS.
120. On balance, given the circumstances in which the FSA found itself at the beginning of the contingency planning period, the difficult judgements taken by the FSA during this period, as it tried to contain the consequences of the crisis for multiple firms that were at risk of failure, were largely sound. It is unlikely any steps that the firm or the FSA could have taken during the contingency planning period would have fundamentally changed the outcome of failure.

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



- 1
121. The FSA's supervision of HBOS after the onset of the crisis is considered further in Part 4, Section 4.8, '*Contingency planning*'.

# 1.7 Recommendations

## 1.7.1 Changes to the regulatory framework and approach

122. Since the events described in this Review, much of the regulatory landscape governing the UK financial services sector has changed. Previous reviews conducted by HM Treasury, the Bank of England, the FSA and the PCBS have all contributed to these changes. Collectively, these changes have addressed many of the failings identified in this Report. Key changes to the regulatory framework in the United Kingdom include:
- the move to a 'twin peaks' regulatory structure where conduct and prudential supervision of banks are undertaken by different regulators, the FCA and PRA respectively;
  - clearer and more focused statutory objectives which refer to effective competition rather than the competitiveness of the United Kingdom;
  - the creation of the Financial Policy Committee (FPC) charged with identifying, monitoring and taking action to remove or reduce systemic risks;
  - the adoption by the Bank of England of the integration of macro and micro-prudential supervision as a core element of its strategy; and
  - the introduction of the Senior Managers and Certification Regimes governing the conduct of individual bankers.
123. Significant regulatory change has taken place on an international level, led by the Financial Stability Board and Basel Committee on Banking Supervision, in particular:
- the introduction of more robust capital and liquidity standards for banks by Basel III (see Part 2, Sections 2.8.6, '*The Basel III liquidity regime: would it have reduced the liquidity risk?*'; and 2.9.7, '*Basel III estimates*');;
  - the forward-looking, judgment-based approach to the supervision of firms which are viewed as domestically or globally systemic, which is also supported by greater resources, and a suite of analytical tools such as stress testing;
  - requirements for recovery and resolution plans; and
  - requirements to hold minimum levels of loss-absorbing capacity, and powers to 'bail-in' certain types of debt.
124. Other relevant changes to the broader regulatory landscape affecting UK banks include:
- significant developments in UK corporate governance standards, and in particular expectations of boards of directors and control functions, following the publication of The Walker Report, *A review of corporate governance in UK banks and other financial industry entities* in November 2009; and

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

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

## 1.7.2 Recommendations for firms

### Management, governance and culture – Board responsibility

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

### Board composition

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

### Senior management relationships with regulators

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

## 1.7.3 Recommendations for regulators

### Will to act

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

## Supervision of international groups

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

## Conflicts of interest

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

