

# PROJECT LORD TURNBULL

## OPERATION HORNET

September 2013

Sally Masterton contact: [Sally.Masterton@lloydsbanking.com](mailto:Sally.Masterton@lloydsbanking.com)  
Mobile: 07802 593550

Thames Valley Police contact: Detective Inspector Tim Hurley

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## NON DISCLOSURE OF THE READING INCIDENT

*"Anything we can do to widen the gap will help the Audit Committee not to disclose, and that is something we seriously don't want to do especially at this moment".* Peter Hickman, HBoS Group Risk Director, 11 February 2002

## AND ITS IMPACT

**At a basic level, if the Reading Incident had been properly disclosed in the 2007 Annual Report and Accounts then it is unlikely that the Rights Issue would have been capable of proceeding and irrespective of whether the Government stepped in or not at that time to prevent the collapse of HBoS, it is unlikely that a solvent acquisition by Lloyds TSB would have occurred.**

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## HEALTH WARNING

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This report comprises the detail from an interview Special Investigator Mick Murphy of Thames Valley Police had with Sally Masterton (Senior Manager, Commercial Banking, Risk) on 10<sup>th</sup> and 11<sup>th</sup> July 2013, in relation to Thames Valley Police's ongoing Operation Hornet (HBoS) investigation under Detective Superintendent David Poole, Head of the Serious and Organised Crime Unit.

Operation Hornet is a large scale investigation into serious financial irregularities involving the former HBoS High Risk & Impaired Assets team, based in Reading.

The extremely serious politically and commercially sensitive nature of the information contained herein necessitate due caution within Lloyds Banking Group.

The interview was conducted in the spirit of Project Windsor 2. No separate Witness Statement has been prepared. Given the important nature of the interview and discussions, including critical information impacting on Lloyds TSB shareholders, Sue Harris, Group Audit Director, requested this report. It contains highly confidential information, which was not previously considered relevant to the Reading Incident.

Thames Valley Police have an interest in the report but have not been provided with a copy. The report contains information, which is material to their investigations.

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## Due Caution Explanation

This report includes information, which is material to Thames Valley Police's investigations, including information relating to serious corporate criminality involving and stemming from the Reading Incident. The report has not been provided to Thames Valley Police.

The report also contains information of a serious regulatory nature. It is highly commercially sensitive.

- ✚ LBG are implicated via Lloyds TSB and are at significant risk financially and reputationally.
- ✚ LBG has potentially serious conflicts to address.
- ✚ LBG is in a very difficult position and can not risk being seen to condone criminality and injustice.
- ✚ There are colleagues remaining in the business who are implicated.
- ✚ Certain customers have been subject to unfair treatment and non compliant conduct pre and post merger by former HBoS employees.
- ✚ The former directors of HBoS and certain senior executives have committed serious breaches and violations of statutory and regulatory obligations, including those of a criminal nature.
- ✚ KPMG have breached statutory, regulatory and professional obligations and duties, including ones of a serious criminal nature. Their misconduct and failings are severe.
- ✚ PwC have breached statutory, regulatory and professional obligations, including ones relating to money laundering offences. Their misconduct is of a serious nature.
- ✚ An allegation has been made, which would suggest that the FSA may have had an involvement together with LBG, in concealing the misconduct and failings of KPMG.
- ✚ The FSA are implicated in the 2008 Rights Issue.
- ✚ Deloitte's s166 investigation in 2009 appears flawed.
- ✚ In 2009 Deloitte may also not have raised concerns into the conduct of senior executives, the directors, KPMG, PwC and certain Insolvency Practitioners.
- ✚ Other Insolvency Practitioners are implicated.



## EXPLANATORY NOTES

This report does not provide details of criminality in cases pertaining to the Reading Incident. References to certain cases have been made for illustrative purposes and points of emphasis. Information in relation to certain individual cases, including details of suspicions of additional criminality, has previously been provided by way of Witness Statement extracts and a presentation briefing pack. More comprehensive case details and evidence were to be provided in a series of meetings with Financial Crime, Audit and Freshfields Bruckhaus Deringer. These meetings are yet to be held and have not been scheduled.

HBoS' decision-making role and the related roles of others in the Reading Incident and subsequent events are explained in this report.

The estimated loss in respect of known Reading Incident cases is £1bn.

Operation Hornet is a large scale investigation. There are however a large number of other cases relating or pertaining to the Reading Incident, which are outside the parameters of Operation Hornet and which give rise to suspicion of criminality. Thames Valley Police are aware of a number of these related cases. However there has not to date been a full internal investigation within LBG to uncover the full extent of the Reading Incident and all criminality, which is potentially very significant.

LBG has been made aware of the magnitude of the Reading Incident. No decision has been made regarding further investigation (Project Windsor 2). Accordingly Suspicious Activity Reports should now be raised.

This report and its contents must be kept restricted and confidential. No separate Witness Statement has been made in relation to the interview by Thames Valley Police on 10 and 11 July 2013. The report has been drafted in the spirit of Project Windsor 2, as requested by Sue Harris, but has not been provided to Thames Valley Police.

This report includes information, which is material to Thames Valley Police's investigations, including information relating to serious corporate criminality involving and stemming from the Reading Incident.

*All reference to Regulation, Law, Accounting and Auditing Standards, Practice Guidance and so forth, is that which was applicable at the relevant times. The report uses terminology and titles in the context applicable to the relevant time period.*

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## INTRODUCTION

In early July 2013, a puzzling series of spreadsheets relating to the Reading Incident and knowledge of documents which Project Windsor had previously Produced to TVP, linked into knowledge and experiences from 1998 to 2010. What had happened internally in relation to the Reading Incident finally made sense. The timing of the Reading Incident meant that it was intrinsically tied into far bigger irregularities.

### David Mills and Quayside

In November 2008 David Mills of Quayside Corporate Services Limited, who was later charged with money laundering and other offences, made the following comment to a journalist in relation to the losses incurred by HBO5 as a result of the Reading Incident:

*"that was because of Basel II coming in -- that would penalise any bank with so many customers in high risk"*

In one simple phrase, Mr Mills had got it right on a number of levels but for the wrong reasons

What no one externally knew was the true "hornets' nest" of which the Reading Incident was a pivotal part.

### Background

From the time of the wider uncovering within the Bank of the Reading Incident, which would appear to be during mid-2006, the Bank, its external Auditors KPMG, Investigating Accountants (including Deloitte) and Insolvency Practitioners, have all portrayed the Reading Incident as having been perpetrated by one single "rogue banker", Lynden Scourfield as a result of a fundamental breakdown in internal controls. Those charged with governance, oversight and control, went without suspicion on the basis of no prior knowledge.

Even to a bystander with no knowledge of the systems of internal control and the financial reporting structures in place, the argument of autonomy put forward lacked credibility

### Money Laundering

Suspensions of money laundering arose in early 2007 on the commencement of the first deep-dive internal inquiry. Despite regulatory and statutory reporting obligations, professional standards and ethics, and other duties, suspicions of money laundering were not reported then or at any point prior to Deloitte's s166 investigation. Even then Deloitte appear only to have reported suspicions in respect of two fees.

Subsequent to the evidence that gave rise to those first suspicions, the known portfolio of Reading Incident cases have not been properly investigated to identify potential criminality and there has been no inquiry to identify further cases.

## EXECUTIVE SUMMARY

- Proper disclosure of the Reading Incident in July 2007 would have rewritten history for HBoS, Lloyds TSB and the Government.
- HBoS should have been a gone concern in February 2008. It was hopelessly insolvent by July 2008.
- The strategy since January 2007, and possibly from 2005, has been to conceal the Reading Incident.
- Concealment set in motion a course of events that has had and continues to have far reaching and very serious consequences, extending to the Lloyds TSB takeover. LBG is significantly exposed.
- Substantial loss has been caused to HBoS ordinary shareholders (to July 2007), the subscribers to the HBoS 2008 Rights Issue (£332m) and to Lloyds TSB shareholders (£14bn) as a result of the actions of those involved. Compensation due to HBoS customers who were directly affected by the Reading Incident may be significant.
- This report explains the rationale to the decisions made to conceal and those who are known or suspected to have been involved.
- HBoS' high risk business strategy, non recognition of distress and avoidance of impairment, liquidity, Tier 1 capital adequacy, creation of an artificial market, Basel II and non disclosure of the Reading Incident are all inextricably linked.
- They were inextricably linked before the start of the financial crisis.
- Deliberate non-disclosure of the Reading Incident in the 2007 financial statements fundamentally added to the crime, and from that point on the deceit escalated as the financial crisis deepened.
- There is evidence of unfair and non compliant treatment of customers.
- The FSA was knowingly and recklessly misled.
- However the FSA influenced the Rights Issue without appropriate due diligence.
- There was a significant deterioration in the Corporate Stressed Portfolio prior to the closing of the Rights Issue in July 2008.
- The Lloyds TSB Circular and Prospectus and the HBoS Prospectus in November 2008, and the December 2008 Supplementary Prospectuses, do not disclose the known stressed cases in HBoS Corporate at that time, which at 30 November 2008 totalled £40bn.
- Lloyds TSB had evidence of the Reading Incident in October 2008, and was otherwise involved.
- There would appear to be tacit impunity for the serious crimes of the directors, KPMG and PwC.
- All those involved have condoned criminality and injustice.



Business relations continued with those who were potentially culpable of money laundering offences, in some instances further funds were advanced, significant fees were paid and in other instances, Insolvency Practitioners sold businesses and assets to those suspected of money laundering.

#### Non Disclosure

Of fundamental concern is that the Reading Incident, the extent of the losses / provisions, the potential criminality and how the Reading Incident was allowed to happen, were not disclosed to shareholders, potential investors and the FSA.

Those charged with governance and KPMG have condoned criminality and are themselves criminally implicated.

Outwith money laundering offences there are other serious breaches, offences and misconduct that have not been duly reported.

Additionally, Lloyds TSB had evidence of suspected serious financial irregularities relating to the Reading Incident in October 2008. However Lloyds TSB were already implicated by way of a relationship with David Mills, and highly suspicious transactions involving HBoS High Risk customers.

Essential information relating to the Reading Incident and the HBoS Corporate stressed portfolio (c.£40bn) was not disclosed to Lloyds TSB shareholders.

Despite the findings of the Deloitte report, the FSA's concerns stem from potential evidence provided by victims of the Reading Incident, the outcome of which was Operation Hornet, a Serious and Organised Crime Unit investigation into potential money laundering offences.

Non disclosure of the Reading Incident in 2007 led to far larger irregularities.

Disclosure of the Reading Incident in the 2007 financial statements, would have given rise to going concern and other serious issues. Subsequent history is likely to have been radically different.

#### The "Hornets' Nest"

The Reading Incident and wider implications raise very serious issues:

- Political
- Economic
- Criminal
- Civil
- Regulatory
- Reputational
- Professional
- Ethical

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## CULPABILITY FOR NON DISCLOSURE

Non disclosure of the Reading Incident was a paramount consideration pivotal to the Rights Issue. Irrespective of the Rights Issue, disclosure of the Reading Incident in the 2007 Annual Report would have had very serious implications for HBoS and raised additional Going Concern issues.

Disclosure to the FSA during 2007 of the magnitude of the Reading Incident as extending into all Corporate distressed and Good Book connections, its true causality, the non recognition of distress and impairment in Corporate, overstatement of regulatory capital, and the serious implications all of these presented in terms of HBoS' risk management framework, governance and external audit, would have severely impacted, if not halted progress in attaining Advanced Status under the Basel II framework. This would in turn have had significant ramifications in terms of regulatory capital requirements and solvency. The reduction in risk weighted assets under the Advanced IRB approach for Retail was a key priority and had been since 2005 when the post merger business model became unsustainable.

Disclosure of the Reading Incident to the market in July 2007 and reporting of suspected money laundering would have had a substantial impact on the HBoS share price, deposits and external credit ratings.

### Those culpable include:

- **Andy Hornby (CEO)**
- **Sir Dennis Stevenson (Chairman)**
- **James Crosby (Former CEO)**
- **Peter Cummings (Corporate CEO)**
- **Sir Ron Garrick, Chairman of divisional Corporate Risk and Control Committee**
- **Mike Ellis (Group FD)**
- **Audit Committee**
- **Other HBoS Board members**
- **KPMG (Auditors and Reporting Accountants)**
- **Peter Hickman (Group Risk Director)**
- **Hugh McMillan (MD Risk, Corporate)**
- **Stewart Livingston (Chief Risk Officer)**
- **Ian Goodchild (Head of Group Risk – Credit)**
- **Steven Clark (Group Risk – Credit, Commercial)**
- **Andrew Scott (Lead Director, London High Risk)**
- **Tom Angus (Head of Impaired Assets)**

### Those who are additionally complicit in relation to the non disclosure but otherwise culpable include:

- **Paul Burnett (Paul Burnett's culpability may extend further)**
- **Corporate Credit Risk Committee, Group Credit Risk and Internal Audit**
- **PwC**

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## THE RISKS FOR LLOYDS BANKING GROUP

### Evidence

LBG is already exposed to significant reputational risk and risk of litigation as a consequence of the documents that Project Windsor previously Produced to Thames Valley Police as evidence for Operation Hornet. Thames Valley Police has also undertaken their enquiry

Operation Hornet is a criminal investigation and the evidence will be heard in Court. It will be a very public affair. The FCA has a strong interest in the case and has continuing liaison with Thames Valley Police. There is already strong media interest, which Thames Valley Police is containing. Evidence to date, which may become public, will impact LBG.

There is additional risk of disclosure relating to the knowledge of Lloyds TSB, the impact of, and fall out from which could be very substantial

The Operation Hornet case will not be a conclusion in itself. The Reading Incident is large and complicated. A number of significant individual cases are outwith the parameters of Operation Hornet. However in investigating the Hornet case, Thames Valley Police has considerable evidence relating to potential criminality in the other cases, which will be referred to the Serious Fraud Office together with untried Hornet cases. It is highly probable that a new inquiry will be opened and all LBG related evidence will pass across



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The documents previously produced by Project Windsor specifically reveal that the Reading Incident was deliberately concealed when it should have been disclosed in the 2007 Annual Report and Accounts, the June 2008 Prospectus relating to the Rights Issue and the November 2008 Circular and Prospectuses relating to the Scheme of Arrangement, Placing and Open Offer regarding the acquisition by Lloyds TSB.

### Consequences

There have been serious breaches of regulatory and statutory duties, and other reporting obligations. Certain of the breaches constitute criminal offences.

The implications are far reaching and extend to issues of fundamental disclosure beyond those relating directly to the Reading Incident, and the roles of the FSA, KPMG, PwC and other accountancy firms.

Substantial loss has been caused to HBoS ordinary shareholders (to July 2007), the subscribers to the HBoS 2008 Rights Issue (£332m) and to Lloyds TSB shareholders (£14bn). Compensation due to HBoS customers who were directly affected by the Reading Incident may be significant.

*HBoS share price was c £10 in August 2006, £10-£11 in February and March 2007, 940p on 2 August 2007 and 634p on February 2008.*

### **LBG Related Issues**

In October 2008 Lloyds TSB received from one of their customers, potential evidence relating to the Reading Incident, which should have given rise to serious cause for concern.

There is additional evidence to suggest that Lloyds TSB was otherwise aware of potential money laundering at the time the Circular and Prospectus for the acquisition of HBos were being prepared, being prior to the AGM.

Lloyds TSB (former Large Corporate, Bristol) are a party to significant suspicious transactions relating to potential money laundering offences. The former Head of Large Corporate based in Bristol and the Relationship Manager both remain in the Bank. There is a possibility that proceeds of crime may extend to relationships originating in Lloyds TSB including The Parkmead Group plc.

Lloyds TSB's due diligence would include review of Corporate Credit Risk Committee Reports. The November 2008 CRC Report reports the stressed portfolio as being £40bn.

An allegation has been made, which would suggest that the FSA may have had an involvement together with LBG, in concealing the misconduct and failings of KPMG.

Matters relating to the Reading Incident were handled poorly in the first half of 2009 and customers were unfairly treated. The subsequent prevarication and distress that has been caused to one particular customer was non compliant, and was further not warranted when those involved knew of potential money laundering in March 2007 and did not report it, and knew of the validity of the customers' claims against Quayside and Lynden Scourfield. The customer has become gravely ill.

The FSA commenced their in-depth inquiries into the Reading Incident in June 2009.

The true nature of the Reading Incident was concealed from the FSA by LBG, albeit perhaps unwittingly.

The shortcomings in Deloitte's s166 report is concerning and suggests either considerable evidence was concealed from Deloitte or they were otherwise complicit. Noting that certain information that was available to Deloitte has also been made available to Thames Valley Police. Deloitte apparently endorse the findings of the Group Risk report (on Credit Limit Control) from July 2007.

KPMG were appointed to project manage the data room. KPMG, as HBos' Auditors and Insolvency Practitioners to certain Reading Incident cases, was severely conflicted.

A number of former senior executives and directors of LBG

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A number of former senior executives and directors of HBOs are involved. The involvement of two senior directors both of whom remain in the Bank, including the former Head of Group Risk-Credit, is evidenced in the documents Project Windsor Produced to Thames Valley Police. The involvement of Stewart Livingston, the former Chief Risk Officer, Corporate is also evidenced but he has recently left LBG. The former Chief Operating Officer of HBOs Corporate Division, Philip Grant remains within LBG at a senior level, he had a pivotal role in events in 2009.

LBG is in a very difficult position and can not risk being seen to condone criminality and injustice.



## DOCUMENTATION PRODUCED BY PROJECT WINDSOR TO TVP

Peter Hickman (Group Risk Director) was aware that impairment in relation to the Reading Incident was an Exceptional Item and material in relation to the financial statements for year ended 31 December 2007.

There were similar considerations regarding the Reading Incident in relation to the Corporate Governance Statement and the "comply or explain" requirement in relation to the fundamental breakdown in Corporate's internal controls, the full background to the breakdown and the actual and potential impact on Corporate.

### Background

Tom Angus (Head of Impaired Assets) was ultimately tasked with compiling a schedule for inclusion in a report to the Audit Committee on which an assessment could be made whether or not to disclose the Reading Incident in the financial statements and Corporate Governance Statement. Peter Hickman wanted to wrongfully argue a case for non disclosure based on audit materiality and isolation.

Peter Hickman acted as liaison between the Audit Committee and Executive Committee, Ian Goodchild (Head of Group Credit Risk), Steven Clark (Head of Group Credit Risk; Corporate), Stewart Livingston (Corporate Chief Risk Officer) and Tom Angus.

### Concealment

The project was initially presented to Tom Angus by Peter Hickman via Ian Goodchild and Stewart Livingston as being part of an exercise to convey the higher level lessons learned from the Reading Incident. Tom was instructed to compile a schedule showing the Reading Incident Impairment Provisions for 2007.

The documentary evidence shows that the schedule Tom ultimately submitted in February 2008 had been contrived to show a total Provision figure that was below an arbitrary measure of materiality of 5% of net income from Group continuing operations. As explained within the detail of this report, the premise for that arbitrary measure was in any event inappropriate to the circumstances.

Tom Angus confirmed that the schedules were compiled in contemplation of the Rights Issue and were compiled within certain artificial "criteria", which markedly reduced the total exceptional amount to within £285m.

One of the "criteria" was to restrict cases to those only having the involvement of Lynden Scourfield and then, not those that migrated into the Stressed Portfolio after Lynden Scourfield had come under scrutiny in January 2007.

y absolute based on £5,708m was £285m. (Underlying Profit before Tax for considerably less at £2,320m.) There are various drafts of the schedule, which were part Livingston, Steven Clark, Ian Goodchild and Peter Hickman. In one exchange of man makes the comment to Stewart Livingston: "We are getting uncomfortably 285m is not a hard limit. Anything we can do to widen this gap will help the Audit disclose, and that is something we seriously don't want to do especially at this per exchange, Peter Hickman raises with Ian Goodchild the issue of reporting the

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## Emails

The 5% arbitrary absolute based on £5,708m was £285m (Underlying Profit before Tax for Corporate was considerably less at £2,320m.) There are various drafts of the schedule, which were shared with Stewart Livingston, Steven Clark, Ian Goodchild and Peter Hickman. In one exchange of Emails Peter Hickman makes the comment to Stewart Livingston: "We are getting uncomfortably close at £265m. £285m is not a hard limit. Anything we can do to widen this gap will help the Audit Committee not to disclose, and that is something we seriously don't want to do especially at this moment". In another exchange, Peter Hickman raises with Ian Goodchild the issue of reporting the fraud.

The actual Impairment Loss incurred with respect to what has been identified to date as Reading Incident cases is in excess of £1bn. An Email from a manager working with Tom in compiling the schedule, queries the accuracy and legitimacy of the schedule, on the basis that it significantly misstated the total Reading Incident Provisions raised to that date (31 December 2007), which the manager says are c.£800m.

The schedule Tom Angus was compiling was significantly and knowingly erroneous.

On 11 February 2008 Steven Clark sent an Email to Ian Goodchild attaching another draft of Tom's schedule. That schedule totalled £266m and comment is made that £22m of 2008 Provisions, which had been raised post year end, had been removed from the £266m. It is patently evident from the schedule that even in relation to the connections on the schedule, significant further Provisions would be required. Steven knows the schedule is wrong and in what seems to be an attempt to force proper disclosure makes reference to the Turnbull Guidance.

Ian Goodchild then sent an Email to Peter Hickman copied in to Tim Thompson (new Head of Group Credit Risk) and Stuart Dickson. Ian points out about the additional but excluded £22m. He further asks Stuart to provide an estimate of the amount of loss that would have been incurred in any event, if the "fraud" had not been committed. He does not point out about the £500m+ that had been excluded.

The schedule submitted on 14 February 2008 totals £262.4m. The schedule is very clearly incorrect.

## Report to the Audit Committee: February 2008

The report ultimately presented to the Audit Committee in February 2008 shows the 2007 Impairment Provision Charge for 27 of the Reading Incident cases as being £266k. The report does however point out that Provisions amounting to £78m had been excluded. The basis of the £78m is unknown and there are clearly significant additional Provisions over and above this that were not included. Nevertheless at £344m, this was above Peter Hickman's initial arbitrary materiality threshold for disclosure.

The report summarises the findings and lessons learned from the July 2007 Group Credit report (Risk Review of the Credit Limit Control Environment) and provides an update on the various initiatives that came out of the review.



# SECTION ONE: REPORT FINDINGS

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### REPORT FINDINGS

At a basic level, if the Reading Incident had been properly disclosed in the 2007 Annual Report and Accounts then it is unlikely that the Rights Issue would have been capable of proceeding and irrespective of whether the Government stepped in or not at that time to prevent the collapse of HBoS, it is unlikely that a solvent acquisition by Lloyds TSB would have occurred.

LBG has some extremely sensitive and impactful issues to address.

Distress and impairment in Corporate division were deliberately concealed from the outset of the merger, with culpability vesting in the Board. The malpractice was intentional to:

- Overstate profits;
- Overstate regulatory capital;
- Overstate credit quality;
- Artificially inflate the share price;
- Mislead shareholders;
- Mislead the FSA;
- Mislead external credit rating agencies;
- Obtain Approved Status under Basel II;
- Mislead Lloyds TSB.

#### The Reading Incident presented risk of discovery

Those charge with governance condoned suspected money laundering and delinquencies associated with the Reading Incident.

HBoS became aware of potentially serious irregularities relating to the Reading Impaired Assets team in March 2004.

It would appear that impairment relating to the Reading Incident was deliberately concealed from early 2005. This coincides with the time when it was becoming apparent and recognised that the business strategy post merger was not sustainable.

Distress and Impairment were concealed with more devious and serious criminal intent from February 2008.

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Many innocent people, shareholders and Reading Incident customers and associates, are victims, and have lost significant amounts of money. In this regard the directors, senior executives, KPMG and others are accountable.

The criminal actions of those who are the subject of this report added another layer of criminality to their misfeasance, being the deliberate harbouring of those known or suspected to have committed money laundering offences in relation to the Reading Incident.

Certain customers have been subject to unfair treatment post LBG. One customer in particular who has been especially badly treated, compiled substantive evidence about Lynden Scourfield and Quayside, and escalated matters to the highest authorities. The situation may have been avoidable without the intervention of the FSA, action to evict the customer from their house has been stayed for the time being pending the outcome of Operation Hornet. In addition to losing their house, the customer thinks that the Bank is still looking to pursue personal guarantees totalling £200k. Evidence on file gives a dim view of LBG. The customer is now gravely ill with a stress related illness.

There is evidence that Lloyds TSB were aware of the Reading Incident, and were otherwise implicated, prior to the publishing of the November 2008 Circular, subsequent Prospectus and AGM to approve the takeover.

Irrespective of a different strategy to redress the Reading Incident, it remains that the roles of KPMG, PwC, former HBoS directors and senior executives, and others in the HBoS 2008 Rights Issue and the subsequent acquisition of HBoS by Lloyds TSB, are very serious matters that need to be addressed.

## **SECTION TWO:**

# **A BRIEF SYNOPSIS OF THE HISTORY THAT GAVE RISE TO THE "HORNETS' NEST"**

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This section provides inside knowledge of the culture and dynamics of Bank of Scotland into HBoS and through to the ultimate demise of HBoS. It explains the motivation and importance at Board level for keeping the Reading Incident concealed.

In essence it can be summarised by the following:

**The Bank of Scotland culture became a necessity for HBoS:**

**"A primary focus on controlling absolute levels of loss."** Executive Committee 17 May

2005 Board Meeting 27 May 2007 **"It could be disastrous if market sentiment moved**

**against HBoS."** Executive Board October 2007

**At a basic level, if the Reading Incident had been properly disclosed in the 2007 Annual Report and Accounts then it is unlikely that the Rights Issue would have been capable of proceeding and irrespective of whether the Government stepped in or not at that time to prevent the collapse of HBoS, it is unlikely that a solvent acquisition by Lloyds TSB would have occurred.**

The Synopsis, is a "cradle to grave" summary, which in its entirety has been moved to Appendix I. The final parts of the Synopsis are copied below.

#### 2006 – The Beginning of the End

George Mitchell announced his successor in mid-2005, Peter Cummings. George Mitchell had been strongly resistant to Basel II intrusion and the project was significantly behind plan. Peter was tasked with delivering the Advanced IRB approach waiver for Corporate. It was utter chaos.

The churn in Corporate was increasing, which put even more weight on entrepreneurial, joint venture and leveraged deals. On entering 2006 a correction in the property market was expected



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*"It could be disastrous if market sentiment moved against HBOs."* Executive Board October 2007

*At a basic level, if the Reading Incident had been properly disclosed in the 2007 Annual Report and Accounts then it is unlikely that the Rights Issue would have been capable of proceeding and irrespective of whether the Government stepped in or not at that time to prevent the collapse of HBOs, it is unlikely that a solvent acquisition by Lloyds TSB would have occurred.*

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but within HBoS, Corporate was under pressure to deliver. Riskier deals were written, including significant secondary retail property deals in Europe. Capital, liquidity and the funding gap had always been a significant risk but the situation was becoming critical. Impairment and distress were clamped down further to maximise Tier 1 capital. It was absolutely essential for HBoS to achieve Advanced Status under Basel II from 1 January 2008 and thereby benefit from the significant reduction in Retail's risk weighted assets (c.£50bn) and the effect that had on regulatory capital. No secret was made of this.

In June 2006 everyone was clearly alert to major economic risks and the developing situation in the USA.

Peter Cummings established the Causality Team in Spring 2006. Corporate High Value cases that migrated into High Risk and Impaired Assets were investigated. They were largely severely distressed on migration. Operational risk was prevalent (including marking of Limits on CBS) and credit risk management and assessment were largely poor. KPMG did not make enquiries of the Causality Team as part of their audit work.

#### Tom Angus (Head of Impaired Assets)

Evidence suggests that the Reading Incident was known about well before 2006. However it would appear that Tom Angus on taking up a new role as Head of [High Risk and] Impaired Assets discovered irregularities in August 2006, that later in January 2007 became known as the Reading Incident. The timing of January 2007 is suspicious and may have been to avoid disclosure in the Annual Report and Accounts 2006. The share price at that time was £10 - £11, and although the impacts of disclosure would have been substantial, HBoS might have survived the impacts at that time (February 2007).

As explained above, the dynamics of the business were in crisis. The mortgage market had changed dramatically since the merger. The Corporate model and portfolio were of serious concern. The only real light on the horizon was the significantly reduced regulatory capital requirement under Basel II Advanced Status and it was essential for survival for this to be attained. All, including KPMG, were fully aware.

In view of Tom's appointment and the data cleansing exercises, which were exposing Reading Incident cases, **there is evidence to suggest that Paul Burnett, Lynden Scourfield and others were attempting to "hide" Reading Incident cases where there is significant suspicion of money laundering.**

The models that were being introduced into Corporate for Basel II necessitated reconciliation of data, which threw out exception reports resulting in a prolonged data cleansing exercise. Due to the importance of Advanced Status, Peter Cummings had a hands-on oversight role in data cleansing, which fed into all HoFs. The balance of evidence would suggest that Tom Angus strongly suspected irregularities in Reading by June 2006, and that through data cleansing exception reports, Corporate Jet Services Limited and other "hidden" Reading Incident cases had been identified. It would appear that Peter Hickman may have disclosed to the Executive Committee on 31 October 2006 that irregularities in Reading had been identified by Tom Angus.

### Concealment

In June 2006 and subsequently, the Board would not want to recognise a £1bn Impairment Provision. Potential Reading issues were and had been prominent within Corporate Credit Committee Reports. Sir Ron Garrick chaired the divisional Risk Committee, which attended CRC meetings and otherwise received copies of reports and Minutes in relation to the CRC.

There is evidence to suggest that there was deliberate avoidance of review and audit of MV High Risk connections by Group Credit Risk, GIA and KPMG, none of whom prior to 2007, and despite the relative size of the Reading High Risk portfolio, had reviewed or audited Reading High Risk cases (with the exception of 2 connections in early 2005). KPMG would be fully aware of the underlap between their work and that of Group Credit Risk in relation to MV High Risk connections.

The Reading Incident was reported to the FSA in March 2007 as a control issue, after the 2006 Annual Results had been announced. On 26 March 2007, the Peer Review team who had been brought in to Reading were provided with strong evidence of money laundering amounting to £11m, involving a number of Reading High Risk cases and David Mills / Quayside. Criminality was not reported through SARs and was not reported to the FSA. The Peer Team had previously become aware of significant suspicious transactions totalling over £20m on 22 January 2007.

A final report was subsequently provided to the FSA around the time the Interim Results were announced on 2 August 2007, and the party line of the Reading Incident being a fundamental breakdown in controls at Reading perpetrated by one individual, Lynden Scourfield, with no financial crime implications, was upheld.

It was a "whitewash" exercise; the first of a number. The FSA were seriously and deliberately misled.

KPMG and Group Credit Risk had undertaken significant investigation, and knew that the report submitted to the FSA was incorrect and deliberately misleading. This timing coincided with the securitisation and syndication markets closing and wholesale markets tightening. It was the real beginnings of the financial crisis in the UK.

### The End

In February 2008 the Annual Report and Accounts for 2007 were announced. The Accounts had been prepared in contemplation of the Rights Issue, which had been strongly influenced by the FSA after they had approved Advanced Status under Basel II.

Disclosure of the Reading Incident at that point in time would in all likelihood have precipitated the collapse of HBoS.

On 29 April 2008, the Rights Issue was announced. The Prospectus was published on 19 June 2008 and on 18 July 2008 the Rights Issue closed. Interim Results for 2008 were announced on 31 July 2008. During this period the Corporate stressed portfolio had grown considerably but was not disclosed to shareholders or the City. Meanwhile the FSA had grave and growing concerns regarding



HBoS, which appear to have started in September 2007, when coincidentally they were first furnished with third party evidence to suggest serious irregularities regarding the Reading Incident.

On 17 September 2008 the acquisition by Lloyds TSB was announced. Lloyds' Circular was published on 3 November 2008 and both Prospectuses were published on 19 November 2008. There had been significant growth in Corporate's stressed portfolio, which at that time was reported to the CRC (and divisional Risk Committee) as being £40bn. The extent of Corporate's stressed and distressed portfolios were also not disclosed in the 17 December 2008 Supplementary Prospectuses, which were published following HBoS' Trading Update on 12 December 2008.

At a basic level, if the Reading Incident had been properly disclosed in the 2007 Annual Report and Accounts then it is unlikely that the Rights Issue would have been capable of proceeding and irrespective of whether the Government stepped in or not at that time to prevent the collapse of HBoS, it is unlikely that a solvent acquisition by Lloyds TSB would have occurred.

The above issues have been broken down and are discussed in the following sections.

## SECTION THREE: TIMELINE

### TIMELINE

It is helpful to represent the events surrounding the Reading Incident, including the complexities and interactions that culminated in the acquisition of HBOs by Lloyds TSB, in a comprehensive Timeline.

The Timeline references facts and refers to evidence, some of which is not contained within the body of the report.

It is recommended that the following Timeline pages are either bookmarked or removed for easy reference.

Date	
Dec 01	<p>In wake of 9/11 and the dot com crisis, Alan Greenspan effected significant and sustained monetary easing. US interest rates are cut from 6.5% to 1.75% and then to 1% in June 2003. Greenspan was pivotal in engineering the financial crisis. He was further a strong advocate of derivatives and securitisations as appropriate vehicles for banks to take risk under the guise of improved risk management, and was pivotal in giving legal and regulatory support for the development of the OTC derivatives market in part because other sources of profitability for larger banks was diminishing. This was a complete breakdown of the prudential guidelines and best practices that had been developed, in favour of a culture of speculation.</p> <p>The above is fundamental to an understanding of the environment in which the infant HBOs found itself. HBOs having a massive funding gap and reliance on Corporate division to assist in funding that gap.</p>
2001 - 2005	<p>The strategy of HBOs Corporate division post merger is one of double-digit growth predicated on commercial property lending, structured and leveraged finance, joint ventures and equity participation, and entrepreneurial relationship lending. BoS' track record outwith The Mound and St Andrew Square is unproven, yet even still High Value Corporate carries significant distressed exposures which are either unreported or have undergone solvent debt rollover into Good Book workout vehicles.</p> <p>Despite the high risk growth strategy, and forced by Board decisions predicated on market sentiment due to the substantial funding gap, impairment and crystallisation of loss are disincentivised through KPIs.</p> <p>SME market share won in England is largely in the South. The London &amp; South High Risk &amp; Impaired Asset portfolio and team grow organically.</p>
2004	<p>Business banking and Corporate remerge.</p> <p>Work begins on preparing for Basel II, IAS Provisioning and IFRS 39.</p>
Mar 04	<p>Evidence is provided to suggest financial irregularities involving a substantial Reading High Risk connection. Evidence also suggests that KPMG may have been made aware.</p>
Mar 05	<p>HBOs Board acknowledge that the shape of the business delivered under the Merger business strategy is untenable and that a crisis has been reached.</p>
June 05	<p>Evidence suggests Hugh McMillan sanctioned a credit application for Seoul Nassau increasing facilities by £1.8m to £20.9m. DACS is £16.6m.</p>
27 Oct 05	<p>KPMG Corporate lead partner Andrew Higgins, Group senior manager Catherine Burnet and Corporate senior manager Lisa Kjørstad are provided with September 2005 Corporate Portfolio Risk Report and October 2005 Corporate Credit Risk Committee Report from which to select year end audit sample.</p> <p>KPMG's audit in relation to impairments and distress takes cognisance of the review work of Group Credit Risk, in respect of which KPMG are copied in all reports and plan their audit work with Group Credit Risk. There is a fundamental underlap in respect of Mid Value High Risk cases, which is patently obvious.</p>

12 Mar 07	February 2007 Days Past Due High Risk listing is calculated. Teams are requested to identify connections likely to require impairment provisions in 2007
Mar 07	Quayside fees are settled by HBOS at c £250k. Full payment is made of all outstanding fees, with the exception of minor fees outstanding on 1 case, which had gone into Administration.
21 Mar 07	A Glade director alerts the Peer Review Team of potential money laundering and provides evidence totaling £11m. It involves a number of Reading High Risk cases and also David Miller. The Team is told that Mills and Scourfield are culpable.
Mar 07	PAK are instructed to carry out an IIR of Corporate Jet Services Ltd
7 Apr 2007	New Century (largest US subprime lender) files for Chapter 11
25 Apr 07	Lynden Scourfield resigns HBOS AGM Trading Statement
14 May 07	HBOS Reading Incident becomes public knowledge following extensive media coverage
May 07	David Miller issues first report into the Reading Incident and Group Risk Special Projects team commence full review exercise into the credit limit control environment, the review appears to include intensive CDD reviews HBOS share price begins its decline from 1153p
12 Jun 07	APMG commence a credit review audit of Reading connections Pre-close Trading Statement
22 Jun 07	Collapse of Bear Stearns hedge fund Countrywide warns of "difficult conditions"
26 Jun 07	FSA rejects Advanced IIR approach waiver application due to issues regarding Corporate. Letter from Lord Stevenson to FSA ensues, citing the threat on share price and how that impacts on funding
Jul 07	Sub prime contagion starts to spread UK commercial property market is in steep decline Securitisation and syndication markets close. Corporate is "unable to sell or write anything"
11 Jul 07	Congressional Hearing on the systemic risks of hedge funds
26 Jul 07	Group Risk Special Projects team presentation of their Credit Limit Control Environment Report (in-depth review into the Reading Incident). The report incorrectly portrays the situation regarding the marking of assets across Corporate. It incorrectly represents the Reading Incident. It states that there was no evidence of financial crime but does not explain that the review carried out by Corporate Financial Crime Prevention was only into Lynden Scourfield personally and additionally included NYC checks. The report is subsequently provided to the FSA. It is misleading.
1 Aug 07	Announcement of Half Year Results. Share price is £9.40
w/e 6 Aug	Scores of Quant hedge funds spark each other in unwinding positions creating substantial losses
9 Aug 07	BNP announces withdrawal of support on 3 money market funds. Global credit markets seize. ECB injects €95bn overnight to bail out troubled hedge funds



12 Mar 07	February 2007 Days Past Due High Risk listing is circulated. Teams are requested to identify connections likely to require impairment provisions in 2007.
Mar 07	Queyside fees are settled by HBOS at c. £250k. Full payment is made of all outstanding fees, with the exception of minor fees outstanding on 1 case, which had gone into Administration.
26 Mar 07	A Clode director alerts the Peer Review Team of potential money laundering and provides evidence totalling £11m. It involves a number of Reading High Risk cases and also David Miller. The Team is told that Miller and Scourfield are culpable.
Mar 07	PwC are instructed to carry out an IFR of Corporate Jet Services Ltd.
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25 Apr 07	Lyndon Scourfield resigns. HBOS AGM Trading Statement.
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12 Jun 07	KPMG commence a credit review audit of Reading connections. Pre-close Trading Statement.
22 Jun 07	Collapse of Bear Stearns hedge fund. Countrywide warns of "difficult conditions".
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Jul 07	Sub prime contagion starts to spread. UK commercial property market is in steep decline. Securitisation and syndication markets close. Corporate is "unable to sell or write anything".
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1 Aug 07	Announcement of Half Year Results. Share price is £9.40.
w/e 6 Aug	Scores of Quant hedge funds spark each other in unwinding positions creating substantial losses.
9 Aug 07	BNP announces withdrawal of support on 3 money market funds. Global credit markets seize. ECB injects €95bn overnight to bail out troubled hedge funds.

- 12 Aug 07 HBoS Reading Incident is raised again in the media
- 13 Aug 07 Goldman Sachs and clients inject \$3bn into global GEO hedge fund
- 17 Aug 07 The FED approves measures to assist liquidity
- Aug 07 UK housing market downturn becomes evident. Lehman, Accredited & HSBC shut offices  
Evidence relating to the Reading Incident is provided to the Board
- 10 Sep 07 Victoria Mortgage Funding is first UK mortgage company to fail
- 14 Sep 07 B of E announces emergency funding for Northern Rock  
Evidence relating to the Reading Incident is provided to the Bank of England
- 17 Sep 07 Following a run on deposits the government guarantees Northern Rock's remaining retail deposits
- Oct 07 Major losses emerge (UBS, Citigroup, Merrill Lynch, Morgan Stanley) following significant writedowns  
FSA evaluation of progress against ARROW assessment
- 4 Oct 07 Further evidence of Reading Incident is provided to Lord Stevenson.
- Nov 07 Pressures on financial markets intensify, reflected in diminished liquidity and interbank funding  
HBoS pay out Lloyds / Sandstone loan guarantees £17.44m.  
Evidence of Reading Incident is provided to the Prime Minister, the TSC, various MPs and the FSA
- 10 Dec 07 Further writedowns at UBS and capital concerns  
James Paice MP writes to Lord Stevenson providing evidence in relation to the Reading Incident and expressing concerns
- 12 Dec 07 B of E, FED, ECB, Swiss Nat Bank and Bank of Canada announce measures to ease pressures in short term funding markets
- 13 Dec 07 Pre-Close Trading Statement.
- 1 Jan 08 HBoS commences operating under the Basel II framework capital ratio regime.
- 22 Jan 08 Significant Q4 losses announced by Citibank, Merrill Lynch. Citibank seeks to raise \$14.5bn in capital  
Market implosion is starting to build.
- 24 Jan 08 Treasury Committee inquiry report "The Run on the Rock" is published
- 17 Feb 08 Northern Rock rescue by UK Government.
- 27 Feb 08 Announcement of HBoS 2007 results. Profits in the retail division are hit by the credit crisis. Despite the stark drop of the global credit crunch and limited growth strategy. Treasury fair value adjustments are just £227m and the Board point to an alleged strong core Tier 1 capital ratio  
Lloyds TSB share price was 457p
- 28 Feb 08 HBoS 2007 results are poorly received by the City. As the UK's largest mortgage and savings provider HBoS was particularly exposed to the global credit crunch. Share price falls to 634p

Mar 08	FSA submit draft ARROW Risk Assessment letter.
3 Mar 08	HSBC announce \$17bn credit crisis losses
11 Mar 08	FED introduces Term Securities Lending Facility and B of E expands funding measures.  Global markets continue to implode culminating in the collapse of Bear Stearns. UK house prices fall at the fastest rate since the recession of the 1990s
11 Mar 08	Corporate RMs are instructed by senior executives not to write new deals.
12 Mar 08	HBoS raises £750m of new capital albeit at 9.5% (3.5% higher than the rates charged to mortgage lenders) as a result of lower revenues from its investment portfolio and higher Libor funding costs.
16 Mar 08	FED launches Primary Dealer Credit Facility
17 Mar 08	Sir Callum McCarthy (FSA) phones Lord Stevenson.
18 Mar 08	Lord Stevenson's strange letter to Sir Callum. A hint is made by Lord S about false rumours in the market creating hit and runs on institutions. Stevenson also lobbies for the B of E to swap mortgage-backed securities.
19 Mar 08	HBoS short-selling triggered by rumours of an approach by HBoS to the Bank of England for emergency funding to enable £128bn of non-customer liabilities to be rolled in the following quarter.  Shares are suspended.  B of E and the FSA give unprecedented denials / statements.  James Paice MP writes to Lord Stevenson chasing a reply to an earlier letter in December 2007 regarding the Reading incident, Lynden Scourfield and Quayside.
28 Mar 08	Mervyn King warned the Treasury Select Committee that the financial crisis had moved into a different phase and expressed concern in relation to the levels of bank capital.
1 Apr 08	Writedowns at UBS and Deutsche Bank total \$23bn.
2 Apr 08	Moneyfacts report that 20% of mortgage products withdrawn from the UK market in the previous 7 days.
8 Apr 08	IMF warns that potential losses from the financial crisis could reach \$1trillion or more, and that effects are now spreading to other sectors including commercial property and corporate.
21 Apr 08	B of E launches Special Liquidity Scheme.
Apr 08	Meltdown continues (Citigroup, Merrill Lynch, UBS, Deutsche Bank)
22 Apr 08	RBS announces £12bn Right Issue and fair value writedowns of £5.9bn. Capital call is a result of credit market positions and to shore up reserves / capital ratios following acquisition of ABN Amro.  FSA final ARROW letter and RMP are received. They contain a number of areas of concern.
29 Apr 08	HBoS AGM and Interim Trading Statement. £2.8-4bn of writedowns on its portfolio of complex debt securities. Heavily discounted £4bn Rights Issue (fully under-written by Morgan Stanley and Dresdner Kleinwort) announced to strengthen capital ratios plus £600m from paying the first half dividend in shares. This was the 3 <sup>rd</sup> largest Rights Issue in UK corporate history and was portrayed as strengthening an already strong capital base in the wake of the deepening credit crisis.  HBoS Rights Issue announcement is badly received by the City. HBoS' capital base position is seen to be a massive u-turn from that presented in February 2008. There were concerns of further deterioration in the UK domestic property and mortgage markets, of the illiquid state of the capital markets and of further writedowns from deteriorating values of toxic assets including below prime Alt-A mortgages.



- May 08 HBOs Reading Incident speculation is reignited in the media and is linked to the collapse of EuroManx.  
James Paice MP writes to Hugh McMillan expressing severe concerns regarding the Reading Incident and being a matter for the regulator and police.
- 14 May 08 Announcement of Bradford & Bingley Rights Issue B&B subsequently collapses.
- 23 May 08 Substantive evidence of financial irregularities regarding the Reading Incident is provided to Peter Cummings, the Prime Minister and Chancellor.
- 9 Jun 08 Lehman confirms loss of £3bn in Q2.
- 4 Jun 08 Posting of HBOs Rights Issue Circular to Shareholders.
- 12 Jun 08 HBOs share price falls below the Rights Issue price of 275p.
- 18 Jun 08 Q2 losses at Morgan Stanley include losses from mortgage proprietary trading.
- 19 Jun 08 HBOs Prospectus published including 5 month Trading Statement.
- 26 Jun 08 HBOs General Meeting to approve Rights Issue.
- 11 Jul 08 Closure of mortgage lender IndyMac.  
US Treasury announces rescue plan for Fannie Mae and Freddie Mac.
- 18 Jul Rights Issue closes.
- 21 Jul 08 HBOs Announcement of result (only 8% take up leaving £3.8bn of "stick").  
However Morgan Stanley had subsequently placed a significant amount of the overhang and had also shorted the stock prior to closing in the certain knowledge of the issue price. They are cleared by the FSA in this respect. Hedge funds had been able to close out some of their positions but there were still significant loss positions held by institutions.
- 24 Jul 08 False rumours of HBOs takeover allow Morgan Stanley and Dresdner to sell another significant holding at a considerable profit. Other institutions close out their positions.  
James Crosbie (FSA) submits report to the Chancellor on options for the housing market crisis. Includes radical guaranteeing of mortgage backed securities by the Government.
- 25 Jul 08 National Australia Bank tumbles.
- 28 Jul 08 Merrill announces further writedowns of \$6bn.
- 31 Jul 08 Announcement of HBOs first half results.
- 1 Aug 2008 FSA abandons investigation into March 2008 trash and cash incident due to lack of evidence.
- Aug 08 Group Credit Risk are permitted access to Joint Ventures to review specific connections. Serious irregularities are discovered and disciplinary action recommended. This is turned aside by Mike Wooderson prior to the completion of the takeover.
- 18 Sept 08 Announcement of recommended acquisition of HBOs by Lloyds TSB.

8 Oct 08	Gordon Brown PM is sent comprehensive information and substantive evidence relating to the Reading Incident.
13 Oct 08	Lloyds TSB receives from one of its customers substantive evidence of financial irregularities regarding the Reading Incident, sufficient to give cause for concern.
3 Nov 2008	HBoS Interim Management Statement (9 months to 30 September 2008). Lloyds TSB Circular is published.
14 Nov 08	HBoS Scheme Document and Circular are published.
18 Nov 08	HBoS and Lloyds TSB Open Offer & Placing Prospectuses are published.
19 Nov 08	Lloyds TSB AGM and approval of acquisition.
12 Dec 08	HBoS Trading Update. HBoS AGM giving approval of Scheme and Capital Raising.
17 Dec 08	HBoS and Lloyds TSB Supplementary Prospectuses are published following the HBoS Trading Update. The extent of stress and distress in the HBoS Corporate portfolio is not disclosed. The Lloyds TSB Prospectus concludes "The HBoS Trading Update is broadly consistent with the impairment analysis conducted by Lloyds TSB as part of its review process in October 2008.
9 Jan 09	Closing of Open Offers.
16 Jan 09	Acquisition of HBoS completes.
Oct 09	The FSA instruct Deloitte to carry out a S166 (Skilled Persons Report) investigation into the Reading Incident.
Jun 10	Operation Homet is launched.

In September 2008 HBoS was twice the size of Lloyds TSB based on total assets (£681.4bn v £367.8bn).

The Lloyds TSB share price had peaked in February 2007 at 622p and in February 2008 (FY 2007 announcement) shares were trading at 457p.

## SECTION FOUR: THE DYNAMICS

*[The following text is extremely faint and largely illegible due to bleed-through from the reverse side of the page. It appears to be a series of paragraphs or a list of points.]*



## SECTION FOUR: THE DYNAMICS

### DISTRESS AND IMPAIRMENT

#### Summary

The HBOs high risk business model followed post merger was predicated on market sentiment. Fundamental to its success was avoidance of impairment and distress in Corporate division:

- The Board set KPIs to restrict impairment and distress, and improve perceived credit quality;
- Regulatory capital was thus manipulated;
- To change the status quo risked a run on deposits, a fall in share price, reduced external credit ratings, increased funding costs and increased regulatory capital requirement;
- From 2005, Basel II and the start of the HBOs crisis had a major impact on the malpractice;
- The Reading Incident would have had a fundamental impact on HBOs and was externally concealed. Internal Management Information tracks the deteriorating trend;
- Oversight functions and KPMG did not review or audit Mid Value High Risk connections in Reading. The underlap is clearly evident. Evidence suggests that this was deliberate;
- The financial crisis severely impacted HBOs from July 2007;
- There were sufficient warning signs, which the FSA acknowledged but actioned too late;
- Reading and levels of distress were concealed from the market, shareholders and the FSA, most critically in and from February 2008.

#### Background

The recession of 1990 – 1993 is interesting as it was during this period within Bank of Scotland that the refusal to recognise large Corporate impairment and crystallise loss was cultured, originally based on the honest intention of either working with the customer, or in respect of property deals, bringing in-house as equity deals to hold pending the up-cycle. Within the Mound (Head Office) however that through the cycle support had manifested itself into another beast all together.

Coming out of the recession, that culture within The Mound and St Andrew Square (Large Corporate) escalated, resulting in more complex deal structures and more risk taking. Gavin Masterton (Governor and Treasurer) and Ian Robertson (MD Corporate Banking) “perfected” loss avoidance through rolling debt into new vehicles owned by “entrepreneurs”, with the Bank often taking a cut of any upsides by way of profit share.

Pre-merger and following the departure of senior Corporate credit risk executives Jim Purves and Colin Leslie, Corporate under the influences of George Mitchell (Chief Executive of Corporate

Division) and Ian Robertson, had become increasingly more covert. Corporate strongly resisted the "intrusion" of High Risk. They refused to formally acknowledge distress and considered that they were best placed to workout situations. Meaning restructure and lend more. They were resistant to normal group oversight functions, with the exception being at Board level.

Ian Robertson had his own Good Book "High Risk" team under Ray Robertson. It was well known within the control functions of Edinburgh. Cases, which were flagged High Risk or Impaired, were "basket cases". Credit sanctioning lacked any real challenge and could never be construed as independent. Despite concerns expressed that the Chief Executive of the division chaired the divisional Credit Risk Control function and thus there was a fundamental flaw in the "first line of defence", the structure was not modified.

By 2003 it had been apparent that the Business Banking strategy (SME penetration into England and Wales) had largely failed and it was therefore left to Corporate to deliver and exceed the aggressive growth target that had been pitched at the merger. Deals became more leveraged, more equity stakes were taken, and entrepreneurial lending spiralled. All assisted by the rising property market, which delivered substantial fee income and profits from the sale of investments. However at the centre was a known core of entrepreneurial lending, which was growing exponentially. Part of that growth was from the restructuring and refinancing of "distressed" connections. Irrespective of those deals, a large proportion of deals lacked sound credit fundamentals. The magnitude of the deals made it impossible to replicate the "Robbo" rollovers of the 1990s in the event of a sustained downturn. With oversight otherwise being by way of the divisional Risk Committee, Board and Audit Committee. Additionally, larger deals were reported to the Board on a monthly basis.

No oversight function was permitted meaningful access to Joint Ventures and Equities. It was only in the second half of 2008 that Group Credit Risk was permitted access to undertake a review of Joint Ventures, and found serious dysfunctional behaviours, operational risk and distress. The conduct of those involved was absolved by Mike Wooderson immediately before the Lloyds TSB takeover completed.

### **Causality**

Peter Cummings (Chief Executive of Corporate Division) created the Causality function in Spring 2006. Bad lending practices in Corporate had snowballed. The extent of potential loss and distress that was being concealed was potentially substantial. Significant new deals were written almost in desperation when there should have been no justifiable commercial and credit reasons for doing so. The reliance on Corporate was extreme. Credit assessment in the larger deals was lacking. Sanctioning of these deals was out of control and most worryingly those deals were being "rubber stamped" by the Board.

Marking of Limits was prevalent resulting in homologation of unauthorised excess positions.

Certain High Value Causality reports were passed to Group Credit Risk and others were discussed at the Corporate Credit Risk Committee. All High Value Causality Reports that were not withheld by Paul Burnett (Head of Impaired Assets) or subsequently David Miller (Head of Corporate Credit Sanction), as being too politically sensitive in relation to the involvement of senior executives, were

circulated to Corporate Credit Sanction and Portfolio Management. The respective Heads of Function and Risk Directors received the Causality Reports for their areas.

Causality reporting was an important process, providing essential information in relation to internal control failure, operational risk, lessons learned and dysfunctional behaviours. KPMG did not request any Causality reports from the team so either did not review important information on causality trends and cases or, assuming KPMG did sight reports chose to ignore findings. David Miller closed down High Value Causality case reviews in late Summer 2007 as the reports were too politically sensitive.

## THE HARD EVIDENCE OF STRESS: 2008

Extracts of the conflicting and misleading information that was contained in information that was released to the market and shareholders is contained in APPENDIX II.

In the following, HBoS announcements and published information during 2008 are considered against what was known within the High Risk environment with regard to Corporate division, and in particular Management Information by way of the monthly Credit Risk Committee reports. CRC reports were also provided to the divisional Risk Committee, and during 2008 almost on a monthly basis to KPMG.

### 27 FEBRUARY 2008: Report and Accounts 2007

**There were serious Going Concern considerations in February 2008 as set out below, irrespective of the Reading Incident.**

These could be argued as subjective but the decision had been made in February 2008 to raise capital via a Rights Issue. That decision was reckless. The 2007 Annual Report and Accounts were prepared and signed off with the objective of the Rights Issue in mind:

- HBoS had been in crisis since 2005;
- Corporate had been unable to write or sell deals from July 2007 (this was not disclosed to the market and false statements were made);
- The FSA had warned, and Group Credit Risk and KPMG were aware, that Corporate's risk rating models were flawed and unreliable. The FSA view was that there was a material risk of overstatement of regulatory capital. In actual fact, and as KPMG and the Board would know, regulatory capital was materially overstated;
- By approving the Advanced Status waivers and then influencing the Rights Issue, the FSA effectively transferred the cost of the risk the FSA had created through capital reduction, to investors. This was not made clear to investors and shareholders;
- Treasury's Liquidity Portfolio could not be realised to generate capital and liquidity;



- Treasury could not raise funds via securitisation or other paper;
- The wholesale funding markets had otherwise tightened. This impacted on the availability and cost of wholesale funding;
- If true credit quality had been disclosed to the market then HBoS' external credit ratings would have been downgraded, the ability to secure wholesale funding would be severely doubted, a deposits run was highly probable and the regulatory capital requirement would increase;
- Credit Default Swaps were already highly volatile and external credit ratings already carried a high risk of down grade;
- The heightened risk of a deposit run had been evidenced in September 2007 at Northern Rock;
- In the absence of realisation of Corporate investments and Treasury securitisations, funding of Retail was precarious;
- Even in a status quo of conditions at that time, with the maturity of wholesale funds, the changing maturity profile and the funding requirement, meant that a capital crisis was inevitable and in all likelihood within 12 months. This was not made clear to shareholders and investors;
- In February 2008 the economic outlook was extremely poor, including the expectation of a significant fall in the UK residential property market, which had been in decline since August 2007.

#### **29 APRIL 2008: AGM STATEMENT AND ANNOUNCEMENT TO THE RIGHTS ISSUE**

In February 2008 the housebuilding industry went into freefall. HBoS was significantly exposed to housebuilders, property development and construction. At the end of February 2008 Crest Nicholson became distressed and in March 2008 formally entered High Risk and Impaired Assets under the direction of David Gibson. Almost immediately afterwards McCarthy & Stone and a number of other significant credits became distressed. During April 2008 referrals from joint ventures, equities, leveraged and entrepreneurs picked up pace. The exposures were very substantial.

**Objective assessment suggests that the FSA should have reasonably known in February 2008, £4bn was never going to be sufficient to provide an adequate capital buffer.**

**Prior to the Rights Issue Prospectus being published on 19 June 2008, it was evident that the amount of capital that was required was very substantial and in all likelihood HBoS was a gone concern.**

### 31 JULY 2008: HALF YEAR RESULTS JUNE 2008

The Interim Results were announced on 31 July 2008, ten days after the Rights Issue had closed. The 30 June 2008 Interims were contained in Lloyd TSB's Circular (3 November 2008) and the HBOs and Lloyds TSB's Prospectuses (19 November 2008).

The 30 June 2008 Interims are deliberately misleading and do not present the true extent of distress in the Corporate portfolio. Knowledge of that distress was essential to a proper understanding of the Interim Accounts.

In the Distressed Portfolio as at 30 June 2008 balances with High Risk status amounted to £2.3bn (DACS £814m) and there were cases totalling drawn £3.5bn, which had been referred as Stressed and were waiting categorisation. The drawn value of cases under Close Monitoring is unknown.

In total in the first half the Distressed Portfolio had increased from £4.7bn to £9.8bn. The Interims report a total figure of £4bn at 30 June 2008 (an increase of £1.5bn from 1 July 2007). The Distressed Portfolio actually increased by £0.5bn in the 5 months ended 31 December 2007 and by £5.6bn /133% in the period 1 July 2007 to 30 June 2008.

Migrations included significant single credits.

Sir Ron Garrick was Chairman of the divisional Risk Committee and attended Corporate Credit Risk Committees, which Peter Cummings chaired, and also received copies of the monthly CRC reports.

In the Interims, given the flaws in the models, Risk Weighted Assets and Expected Loss were again but more significantly understated, with the consequent overstatement of the Core Tier 1 capital ratio. The understatement of Corporate RWA should have been evident to the FSA.

KPMG reviewed Impairments as part of the scope of their work in connection with Interims.

Of further concern is the entrepreneurial, equity and leveraged deals that were struck in the first half of 2008. A number of these deals lacked any credit fundamentals, lacked security and exposed the Bank to even greater risk. The directors would be aware of these deals via the monthly Advances Schedules. It is not known why at the very least in January 2008 the directors did not formally clamp down hard on credit appetite. The directors knew that they were not taking "a cautious approach" and to say otherwise is grossly misleading.

In relation to Leveraged loans the FSA risk review specialists had a remit to complete a review of the Leveraged portfolio by 15 May 2008. The findings should have been such to give severe cause for concern. Additionally a "Credit Risk" visit was undertaken in June 2008.

### Going Concern Considerations at 1 August 2008

The view has been taken by analysts that losses of £7bn would have required HBoS to be recapitalised.

The IFRS requirement for directors to make an assessment of the entity's ability to continue as a going concern also applies to interim financial statements. Going Concern and principal risks and uncertainties change over time as a business develops and as the business environment changes. Thus these disclosures need to be revisited when preparing each set of annual or interim report and accounts.

Before the Rights Issue closed and on 1 August 2008 there were fundamental Going Concern considerations. Leaving aside the position with regard to the closure of the Rights Issue, if the assessment of fundamental uncertainty is correct as at 1 August 2008, then the directors should have disclosed that there was fundamental uncertainty in the Interim Accounts, and made clear disclosure of the nature and implications of the uncertainty. The Interim Accounts would otherwise be seriously misleading. With a Distressed Portfolio of c.£9.8m and growing, with no sign of abatement in the economic crisis, then it is hard to conceive how HBoS could turnaround that magnitude of debt. Disclosure of the Reading Incident at that time would likely have had a substantial adverse, if not most probably terminal affect on HBoS.

### INTERIM MANAGEMENT STATEMENT 3 NOVEMBER 2008

The Corporate Stressed Portfolio totalled £40bn as at 30 November 2008. (This compares with total Corporate profit since 2001 of £9bn.)

The Interim Management Statement (IMS) is deliberately misleading and does not provide essential information relating to distress within the Corporate portfolio. The IMS was contained within the Circular issued by Lloyds TSB on the same date.

The IMS contains Management Information for the 9 months ended 30 September 2008. The IMS discloses the Corporate impairment charge for the year to date of £1.7bn. At 30 September 2008 the Distressed Portfolio contained High Risk cases totalling drawn £3.5bn carrying a DACS of £1.9bn, and there were a further £2bn of cases pending classification. This is not disclosed, nor is the sharply increasing trend to Impairment which had been experienced since April 2008. The contagion had spread to HBoS exposures in Leisure related businesses and the Retail sector. The Pubs sector was a real cause for concern. Within High Risk, there had been a total of £4.4bn of new cases in the period and migrations to Impaired of £1.9bn. From April 2008 a significant amount of cases had been migrating from Good Book straight to Impaired.

At 31 December 2007 the Corporate Distressed Portfolio had totalled drawn £4.7bn. At 30 September 2008 it totalled Drawn £11.7bn. The drawn of cases in Close Monitoring is not known.



The Executive Summary of the CRC report comments that provision levels, trends and concerns had been discussed with KPMG, and that there had been a real pace in the deterioration of the economic environment over recent weeks. "The extent of such trends and potential volatility arising cannot be underestimated"

In the Summer of 2008 Group Credit Risk were permitted access to Joint Ventures to undertake a portfolio review of certain connections. This was the first time they had been permitted to undertake deep-dive investigation. Significant irregularities were discovered. Those culpable were ultimately absolved by Mike Wooderson, immediately before the Lloyds TSB acquisition concluded. This was a form of judicial review process as a result of strong representation for disciplinary action by Group Credit Risk and push back by Peter Cummings. Causality similarly later found significant irregularities including breach of Joint Venture rules whereby loans and facilities were provided via the Entrepreneurs team to fund equity stakes, loans and capital for counterparties. These breaches of obligations are serious, and extend to the main Board via the Advances Schedules, divisional Corporate Risk Committee and the Audit Committee.

On 1 August 2008 the FSA met with Peter Cummings to discuss their investigation findings to date and the serious concerns these raised. On 17 October 2008 the FSA wrote formally to Peter Cummings, enclosing an updated RMP. This letter gave rise to the referral to Enforcement.

On 13 October 2008, Lloyds TSB were provided with evidence in relation to the Reading Incident, which should have given rise to considerable cause for concern.

Lloyd TSB's Circular to shareholders was issued on 3 November 2008, the same date as HBOs' Interim Management Statement, and contained the Interim Management Statement.

#### CORPORATE CREDIT RISK COMMITTEE REPORT 30 NOVEMBER 2008

Significant impairment charges were booked in October 2008.

The year to date impairment charge rose from £1.7bn at the end of September to £3.3bn. The charge was £602m for the year ended 31 December 2007 and £469m in the 6 months ended 30 June 2008.

The total Distressed Portfolio had risen from £4.7bn at December 2007 to c.£15bn as at 30 November. Connections under Close Monitoring amounted to a further £25bn. The total Stressed Portfolio was c.£40bn.

Total adjusted capital resources under Basel II (adding back EL and the Bad Debt charge, and deducting the Rights Issue proceeds and Collective Provision) as at 30 June 2008 amounted to £38bn.

The CRC report was provided to KPMG. The first draft of the report had been completed on 17 December 2008 and was presented prior to the Christmas break.

On 12 December 2008 HBoS issued a trading update in advance of shareholder meetings on the same date to approve the placing and open offer, and the acquisition by Lloyds TSB.

The trading update resulted in Supplementary prospectuses being published. These were published on 17 December 2008. THE SAME DATE AS THE FIRST DRAFT OF THE 30 NOVEMBER CRC REPORT.

NEITHER THE TRADING UPDATE NOR SUPPLEMENTARY PROSPECTUSES DISCLOSE THE EXTENT OF STRESS AND DISTRESS IN THE CORPORATE PORTFOLIO.

LLOYDS TSB CONCLUDED "THE HBOS TRADING UPDATE IS BROADLY CONSISTENT WITH THE IMPAIRMENT ANALYSIS CONDUCTED BY LLOYDS TSB AS PART OF ITS REVIEW PROCESS IN OCTOBER 2008. ".....THE ADDITIONAL IMPAIRMENT LOSSES BEING INCURRED BY HBOS ARE NOT CURRENTLY EXPECTED TO HAVE A SIGNIFICANT IMPACT UPON THE SIZE OF THE NEGATIVE CAPITAL ADJUSTMENTS THE GROUP IS LIKELY TO MAKE UPON ACQUISITION."

The HBoS and Lloyds TSB Open Offers closed on 9 January 2009.

Lloyd TSB's acquisition of HBoS completed on 16 January 2009 following the final Court approval.

#### EVIDENCE IN BOARD MINUTES

Sample evidence from Board and Executive Committee Minutes is contained in Appendix III.

In considering the comments made in the Minutes, cognisance should be taken of KPMG's role as Auditors and of the requirement for them to exercise professional scepticism, which they were obliged to do when considering the risk aspects of the comments made in relation to misstatement and non disclosure in financial statements. [KPMG would review Board Minutes as a matter of course in an audit.]

## CORE BANKING SYSTEM ("CBS")

Crucial to an understanding of the Reading Incident and the fundamental internal control failure in Corporate in relation to the marking of Limits, is a brief overview of CBS.

### Background

In 2001, Corporate and Business Banking sterling accounts transferred banking platforms to CBS. A fundamental weakness in the system was immediately highlighted by High Risk & Impaired Assets, Risk, Portfolio Management and Credit Sanction. Limits could be marked or instructed by frontline relationship managers giving rise to unauthorised excess positions, which were concealed via the marking of the Limit.

The intention had been to allow flexibility to permit temporary and occasional "excesses" to cover BACS payments (e.g. wages), which could not be processed without the account being in Limit. The abuse of CBS was prevalent across Corporate and Business Banking, and despite the issue continually being raised and reported by Assurance, Risk and Causality, eventually by way of Operational Risk Event Reports, the abuse was permitted to continue.

**The unauthorised and uncontrolled marking of Limits was a significant risk for the business and was prevalent. It was a fundamental failing in internal control. It had been identified soon after CBS became live.**

Certain Good Book line managers would pull Master List and Event History reports from CBS for their Relationship Managers, periodically as an oversight function, and particularly when carrying out portfolio reviews. It was extremely difficult to monitor where complex facilities were in place, including foreign currency accounts or accounts which sat outside of amalgamated group positions. However for the majority of connections, this routine was an extremely powerful tool to identify dysfunctional behaviour.

Credit Sanction was frequently put in the situation of having to homologate excess positions.

### The Reading Incident

David Miller was Head of Credit Sanction and was fully aware of the risk that the marking of Limits presented across Corporate. David Miller headed up the GIA and Group Credit Risk special investigation into the Reading Incident.

The Reading Incident was reported by HBoS to the FSA in March 2007 after the 2006 Annual Report and Accounts were announced on 28 February 2007. David Miller's interim report was issued in May 2007 and on 26 July 2007 the final report was issued. Neither report disclosed that the marking of Limits was prevalent across Corporate.

**26 July 2007 HBoS Group Credit: Risk Review of the Credit Limit Control Environment**

The FSA was provided with a copy of the July 2007 report, which was effectively a "whitewash" of the true extent of, criminality in, and governance issues surrounding the Reading Incident. It identified "the access controls" weakness in CBS but did not explain that the abuse was prevalent across Corporate. In fact it comments:

"Our testing indicates there is not an endemic limit abuse issue ... within the wider CB [Corporate] environment "

That statement is untrue and as Head of Credit Sanction, David Miller was aware of the untruth. Causality had reported it to him many times and he was also aware from his own sanctioning teams of the number of excess homologation submissions that were received. Nevertheless, the FSA should have recognised that credit control across Corporate was severely compromised. In fact they probably did as they had scheduled to review credit control in Q4 2007, however the pressing requirement of the Advanced IRB approach waiver took precedence. It is not clear whether or not they had considered the role of KPMG as a potential contributory factor in the Reading Incident

The report avoids any reference to the Management Information provided to, and role of, the Credit Risk Committee and Risk Committee, and in particular the detailed High Risk information provided by way of the CRC report.

Corporate Financial Crime Prevention ("CFCP") did carry out a restricted scope review in Spring 2007. However the scope was extremely limited and did not extend to consideration of money laundering offences outwith Lynden Scourfield personally (restricted to within BoS). Additionally limited KYC checks were undertaken. CFCP were instructed after suspicious money laundering transactions were known but that knowledge was either not imparted or if it was, it was excluded from scope.



### "Reporting" of the Reading Incident

The "whitewash" or deliberate misleading of the FSA comprised:

- Limitation to one "rogue" employee;
- Lax risk management controls within the High Risk environment;
- Confession to CBS access controls but concealment of the prevalence of abuse across Corporate;
- Confession to inadequate sampling by Group Credit Risk; and finally and the least improbable of all:
- Avoidance of culpability by senior executives.

In relation to the latter the existence of, and level of detail contained within Corporate Credit Risk Committee monthly reports is not divulged in the report. KPMG are complicit. The executive lead on the report was David Miller, Head of Corporate Credit Sanction. The report distribution list comprised:

Peter Cummings, Chief Executive, CB  
Hugh McMillan, Managing Director, CB  
Stewart Livingston, Managing Director, CB  
David Fryatt, Head of GIA  
Philip Grant, Managing Director, Retail Division  
Gordon Grieve, Managing Director, Strategy & International  
Dan Watkins, Group Risk Director  
Andrew Higgins, KPMG  
FSA

The FSA had been first advised of "control issues" at Reading in March 2007. The FSA had also been advised that Group and Corporate Financial Crime Prevention were investigating potential fraud. In both these regards Hugh McMillan had verbally informed Julie Gregory, who had been in charge of the HBOs Supervision Team at that time.

### Group and Corporate Financial Crime Prevention

Despite there being evidence to reasonably raise suspicions by the Peer Review team of money laundering in January 2007 and their having been formally alerted on 26 March 2007 to strongly suspicious transactions totalling £11m with a subsequent stream of large and suspicious transactions thereafter, the scope of the review undertaken by Group and Corporate Financial Crime Prevention was extremely limited, and was contained to Lynden Scourfield personally and to KYC checks relating to David Mills. The Financial Crime Prevention investigation was closed on 13 August 2007.

**Notwithstanding the fact that the investigation itself was unacceptable and totally remiss, GFCFP report commented:**

*"some of the money trails are difficult to follow as funds were remitted offshore" "suspicions regarding a [bank] exit fee which he [an Insolvency Practitioner who had raised suspicions] was instructed to send to a business account... established that funds were moved between Mills accounts to an offshore account with another bank.....and was not sufficient evidence to confirm criminal activity"*

Of additional concern is that Lynden Scourfield's laptop had not been secured when he surrendered it to the Bank when suspended from duty on 22 March 2007. Policy was not followed and the laptop was immediately sent to be reconditioned with the result that the hard drive was disposed of. Who authorised this is unclear but under policy it is likely that that person would have been either Andrew Scott or David Miller.

**It has to be considered that Group Credit's report in July 2007 should have prompted a s166 Skilled Person's Report (investigation) by the FSA at that time.**

The timing of the report coincided with the tightening of the credit markets. There was no particular up-tick in the volume of referrals into High Risk to December 2007 so it must be concluded that there was no corrective review for distress in the Good Book by Group Risk or KPMG.

## BASEL II

A simple and high level walkthrough of Capital Requirements, sufficient for the level of understanding required for potential jury evidence is attached as APPENDIX IV.

## BASEL II AND THE READING INCIDENT

### Introduction

Basel II was laudable in theory being the improved engagement of senior management in credit risk management and credit decisioning, with the intention of allowing flexibility in the calculation of regulatory capital to reflect the risks inherent in a bank and its assets. Generally and theoretically speaking, this meant that the greater risk to which the bank is exposed, the greater the amount of capital the bank needs to hold to safeguard its solvency and the overall stability of the economy.

Under Basel I, HBoS had manipulated the Specific Impairment Provision and distress to maximise the calculations of regulatory capital and capital adequacy ratios.

Where Basel II fell down in relation to HBoS and KPMG was with regard to what the FSA called "a high level of moral hazard", or in other words, dishonesty, deception and plain fraud, to which the FSA was ironically live.

The risks were clearly apparent, and recognised by the FSA during 2006 and 2007 as part of their Basel II implementation supervision. It is inconceivable that in contemplation of the Rights Issue that the FSA did not conclude their priority RMP actions (investigations) prior to the Prospectus being issued or preferably before the announcement was made at the end of April 2008, given they, to a great extent had created the requirement for an increased buffer through approving Advanced Status.

### The Importance of Approved Status

The reduction in regulatory capital requirements under the Advanced IRB approach to credit risk capital under Basel II for Retail was very significant had been given absolute priority within Corporate. It was not a distraction within HBoS as has been alleged.

The theory of Basel II assumed that firstly management would be incentivised to improve credit risk management and secondly any surplus capital would be used as a cushion. The theory as far as HBoS was concerned failed irrespective of the financial crisis. The theory failed because HBoS was chained into the effects of its risky business model. That model had become unsustainable in 2005 with no fall-back strategy, given the inherent magnitude of capital that was required.

HBoS was "cornered". The ability to give a false perception to the market was faltering. Management considered ways to force their business model to give the appearance of working. This involved ever riskier Corporate lending and increased the attractiveness of reduced regulatory capital under Basel II Advanced Status.

Advanced IRB approach for Corporate was essential reputationally but fundamentally because of Retail (one waiver was approved on a group basis).

### High Risk and Impaired Assets

In 2004, preparations for Basel II, Pillar 3, IAS Provisioning and IFRS 39 began in Corporate. High Risk and Impaired Assets were heavily involved at all stages.

Data from the High Risk & Impaired Assets portfolio was an essential part of the Basel II preparations. Paul Burnett, a number of the Reporting Team members and other colleagues were intrinsically involved in a number of modelling and implementation projects for Corporate division including those relating to Loss Given Default, the Collective Provision, Nexus (Internal ratings), data cleansing, Days Past Due Reporting and the Bad & Doubtful Debts Return.

Whereas under Basel I the clear objective, as evidenced by KPIs, was to minimise the Specific Impairment Provision, in preparing for Basel II, Paul made it very clear in conversations from 2005 that there were serious concerns at Board level relating to regulatory capital under Basel II and in particular Tier 1 capital. There would be a significant capital cost in respect of High Risk connections. As such from 2006 there was considerable pressure from Peter Cummings to return High Risk connections to the Good Book, which would have the effect of improving ratings and RWAs, and reducing the Excess Expected Loss deductions.

Corporate division built an internal ratings model for credit risk called Nexus. Analysis of an obligor's financial statements together with qualitative assessment was then calibrated to the historic statistical data of default to give a Probability of Default rating. Similarly Loss Given Default was generated from historical statistical data of loss. The Expected Loss was thus heavily dependent on historic trending and data. If that historic data had been manipulated to underestimate default and contain loss, which HBoS had aggressively done to date, then Expected Loss would also be underestimated, which it was. Additionally for internal ratings to be reliable, they require "through the cycle" historic data, which Corporate did not have. Anything they did have was distorted due to non recognition of distress.

To illustrate the point of how internal models can be manipulated to reduce capital requirements, a BIS study in 2013 required 15 banks to run their risk weighting models on an identical sample portfolio. The banks were spread and reported capital requirements varying from €3.4m to €34.1m for the same portfolio.

Interestingly it is precisely these two points that David Mills focused on in his conversation with the journalist in November 2008.



The comments are perhaps indicative of Mills' potential defence, which will probably be that he was assisting HBoS in avoiding the crystallisation of loss and was acting under the authority of Paul Burnett, whose perceived authority he had no reason to query. The potential defence is borne out by evidence from Summer 2006, that appears to show that for Reading Incident cases, where the most substantial money laundering offences are suspected, Paul Burnett, Lynden Scourfield and Julia Harrison were actively trying to restructure those cases and return them to the Good Book, thus hiding them from Tom Angus and prevent discovery via the data cleansing exercises.

*[Note: There is evidence to suggest that KPMG and the Board became aware of the Reading Incident in 2004. In Spring 2005 Group Finance and Risk, and KPMG (in their role as Auditors) had carried out a review exercise into the Robustness of Provisioning Policy in Corporate. That review included a review of Mezzanine plc.]*

#### The Reading Incident Impact

Advanced Status comprised approval from the FSA to adopt Advanced approaches for measurement of both credit risk (the Advanced Internal Ratings Based approach) and operational risk (Advanced measurement approach) under Pillar 1.

The Reading Incident in terms of the extent of the fundamental breakdown in credit risk internal controls and oversight functions, the magnitude of loss and impairment, reputational risk, governance issues and fraud and money laundering, would have had a pivotal bearing on the FSA. The issues extended to KPMG, group functions, Board level and substantial operational risk. On balance it has to be concluded that if the FSA were made aware of the true extent of the Reading Incident during 2007 then it is highly unlikely that the FSA would have approved either of the Basel II Advanced approaches for adoption on 1 January 2008.

It should also be borne in mind the crisis HBoS was already in by Summer 2007. It is hard to conceive at that time and any time subsequent, how it would be able to trade out of its difficulties, and it must therefore be concluded that in all probability it was hopelessly insolvent in Summer 2007.

# SECTION FIVE: THE FSA

## SECTION FIVE: THE FSA

### THE FINANCIAL SERVICES AGENCY

*"The potential impact of a serious failure in the calculation of Regulatory Capital is severe."* FSA draft  
ARROW letter - March 2008

#### Background

Emanating from the deregulation of the market ("big bang") in the 1980s, the FSA was set up to assume responsibility as the UK's single regulator.

Although the FSA was incorporated as a private limited company, implying that regulation was endogenous i.e. rooted within the markets and detached from government intervention in its day to day activities, in reality the FSA was a public body exercising public functions, and accountable to Parliament and the judiciary, with Treasury retaining overall responsibility.

There are some quite substantial conflicts of interest relating to the FSA:

- Conflict between duties as UK Listing Authority and as prudential regulator;
- Conflict with "Big Four" and other large Accountancy firms;
- Funding entirely dependent on the firms subject to regulation through fines, levies and fees.

One of the FSA's four statutory obligations was financial stability. Financial stability can only be ensured through cooperation between a central bank, other safety net players (lenders of last resort) and regulators. The link between the FSA and financial stability was therefore designed to minimise the adverse impact of a bank failure on the efficient running of the economy or capital markets.

## THE INFLUENCE BEHIND THE RIGHTS ISSUE

Those charged with governance and KPMG chose not to report truthfully to the FSA in accordance with their obligations and duties.

HBoS' high risk strategy was known from the outset. The directors were constantly fighting a significant funding gap. A Plan B does not appear to have ever been considered. The FSA had a role in ensuring there was an appropriate contingency plan in a downside and in a disaster scenario. Stress Testing was carried out. However based on flawed information, Stress Testing of itself could only be flawed. The FSA via their knowledge of Corporate's credit ratings models ought reasonably to have known that Stress Testing was flawed.

In February 2008 the FSA, in view of the deepening financial crisis and their assessment of the economic outlook, heavily influenced HBoS to raise the core Tier 1 capital ratio to 7% (i.e. by £4bn) through a Rights Issue.

Effectively "the cost" of risk associated with approving the Advanced IRB Approach waiver was transferred onto subscribers to the Rights Issue.

The FSA must be construed as being material to that decision and therefore owed some form of duty of care to shareholders and potential investors, as well as those who ultimately subscribed.

When capital raising was discussed with the FSA and the possibility of a Rights Issue explored, the FSA had a conflict of interest. That conflict intensified during 2008 through to the publishing of the Prospectus in June 2008 as the financial crisis deepened. As prudential regulator, the FSA were concerned in relation to capital adequacy. In its role as the UK listing authority it was concerned to protect shareholders and investors.

### "Due Diligence"

The full ARROW risk assessment undertaken at the end of 2007 had not reviewed Corporate division's High Risk portfolio comprising significant exposures in joint venture, equities, highly leveraged, entrepreneurial, property development and commercial property deals, all of which had been adversely affected since July 2007 and given their nature would rapidly become stressed in the event the financial crisis spread further and was prolonged. The FSA knew this.

The FSA additionally had not conducted its own inquiries into the Reading Incident. Appropriate inquiry would have highlighted suspicious activity and suspected money laundering. Appropriate



inquiry should have cast significant doubt into the conduct of the directors, senior executives and KPMG [Deloitte's 2009 s166 Skilled Person's Report, did not raise concerns in this regard, which were clearly apparent. However they may verbally have voiced concerns, which don't appear to have precipitated appropriate action.]

In influencing the decision to raise capital via a Rights Issue, the FSA relied on Group Audit, Group Credit Risk and KPMG, none of which were independent. That reliance was ill-placed and the FSA ought reasonably to have been aware that the functions were not independent.

The FSA placed reliance on Basel II internal ratings when assessing credit risk and the health of the Corporate portfolio yet knew those ratings were unreliable. The Corporate models were flawed in many ways including the very obvious failings of being highly subjective, based on out of date financial information and out of date valuations (with many deals completed at or near the peak of the market), and artificial credit cycle histories. It is difficult to comprehend how the FSA could rely on the Basel II information for Corporate, when they themselves on a purely objective basis would not have approved Corporate's Advanced IRB approach waiver. They bowed to pressure from Lord Stevenson and James Crosbie when they clearly knew that the Corporate models were not fit for purpose. They knew that:

*"The potential impact of a serious failure in the calculation of Regulatory Capital is severe."*

It should have been reasonable to conclude that Risk Weighted Assets and Expected Loss were significantly understated. Consequently the capital position and capital ratios as at 1 January 2008 were significantly overstated. It also has to be borne in mind the significant reduction in the RWA of Retail (£50bn) that had been achieved from the approval by the FSA of the Advanced IRB approach waiver (note: the waiver is on a bank basis and not by individual divisions). The subscribers to the Rights Issue effectively bore that cost.

Management information was available to the FSA on which an informed assessment could be made in February 2008, prior to the announcement of the Rights Issue in April 2008 and prior to the publishing of the Prospectus in June 2008. Management Information should have been closely scrutinised in any event throughout 2008.

In February 2008 the housebuilding industry went into freefall. HBoS was significantly exposed to housebuilders, property development and construction. At the end of February 2008 Crest Nicholson became distressed and in March 2008 formally entered High Risk and Impaired Assets under the direction of David Gibson. Almost immediately afterwards McCarthy & Stone and a number of other significant credits became distressed. During April 2008 referrals from joint ventures, equities, leveraged and entrepreneurs picked up pace. The exposures were massive.

Assessed purely objectively based on facts the FSA should have reasonably known in February 2008, £4bn was never going to be sufficient to provide an adequate capital buffer.

The Turnbull Guidance specifically provides in relation to the Internal Control Statement:

**"It [the Board] should also DISCLOSE the process it has applied to deal with material internal control aspects of any significant problems DISCLOSED in the annual report and accounts."**

The Auditor's responsibility with regard to the Statement of Internal Controls is to ensure that reporting is transparent and where there has been material non-compliance then disclosure is full and frank.

## Internal Control: Guidance for Directors on the Combined Code (The Turnbull Guidance (2005))

The Turnbull Guidance outlines broad principles on internal control. This principles-based approach was designed to enable Boards to think seriously about control issues and to apply the principles in a way that appropriately dealt with the circumstances of their businesses. It further required directors to use their judgement in reviewing how the company has implemented the requirements of the Combined Code relating to internal control, deciding whether or not they have complied, and reporting to shareholders thereon.

The Turnbull Guidance is thus not a set of prescriptive procedures but a framework that enables the Boards of companies to adopt a risk-based approach to establishing a sound system of internal control, which is then incorporated by the company within its normal management and governance processes.

In this context any specific risk management or internal control issue should be transparently described and dealt with as part of a transparent communication process.

*The Turnbull Guidance (2005) states that "the annual report and accounts should include such meaningful, high-level information as the Board considers necessary to assist shareholders' understanding of the main features of the company's risk management processes and system of internal control, and should not give a misleading impression".*

Of paramount importance in underpinning The Turnbull Guidance was the Internal Control Statement "which taken with the Operating and Financial Review, provides an opportunity for the Board to help shareholders understand the risk and control issues facing the company, and to explain how the company maintains a framework of internal controls to address these issues and how the Board has reviewed the effectiveness of that framework".

Pivotal to The Turnbull Guidance was the doctrine that a sound system of internal control contributes to safeguarding the shareholders' investment and the company assets.

The Guidance further provided that reports from management should identify any significant control failings or weaknesses and should further discuss the impact any such issues have had, or may have on the company and the actions being taken to rectify them. In this context it is important to take cognisance of the roles and interactions of Peter Hickman, who was the Group Risk Director and a member of HBOs' Executive Committee, the Audit Committee, members of Group Credit Risk and other senior executives.

all material controls, including financial, operational and compliance controls and risk management systems.

### **Main Principle C.3 – AUDIT COMMITTEE and AUDITORS**

The Audit Committee has not complied with the Principle and Provisions of the Code in relation to KPMG as external auditor and the integrity of the financial statements and Interim Results, announcements made to the stock exchange and the 2008 Prospectuses. The non-compliance is of a serious nature.

The Board should establish formal and transparent arrangements for considering how they should apply the financial reporting and internal control principles and for maintaining an appropriate relationship with the company's auditors

The main role and responsibilities of the Audit Committee are set out in provision C.3.2, and include

- The responsibility of monitoring the integrity of the financial statements and of any formal announcements relating to the company's financial performance, of reviewing significant financial reporting judgements contained within the financial statements;
- The responsibility to review the company's internal financial controls and, unless the duty of a separate Board Risk Committee, or the Board itself, to review the company's internal control and risk management systems;
- The responsibility to review and monitor the external Auditor's independence and objectivity and the effectiveness of the audit process, taking into consideration relevant UK professional and regulatory requirements;
- The responsibility to develop and implement policy on the engagement of the external Auditor to supply non-audit services, taking into account relevant ethical guidance.

Provision C.3.7 provides the requirement for the annual report to explain to shareholders how, if the Auditor provides non-audit services e.g. engagement as Reporting Accountants, Auditor objectivity and independence is safeguarded.

Finally when considering the misconduct of KPMG, cognisance should be taken of the Combined Code (2003) which made it the responsibility of the Audit Committee to address the independence of the external auditors in the provision of both audit and non-audit services. (The Combined Code (2008) took this further and required disclosure in the Annual Report as to how auditor objectivity and independence is safeguarded.)



### **Main Principle C.1 – FINANCIAL REPORTING**

**The directors have not complied with the Principles and Provisions of the Combined Code in relation to their responsibilities for financial reporting. The non-compliance is of a serious nature.**

**The board should present a balanced and understandable assessment of the company's position and prospects.**

#### **Supporting Principle**

The board's responsibility to present a balanced and understandable assessment extends to interim and other price-sensitive public reports and reports to regulators as well as to information required to be presented by statutory requirements.

#### **Code Provisions**

- The directors should explain in the annual report their responsibility for preparing the accounts and there should be a statement by the auditors about their reporting responsibilities.
- The directors should report that the business is a going concern, with supporting assumptions or qualifications as necessary.

This responsibility extends to interim and other price-sensitive public reports and reports to regulators as well as to information required to be presented under statutory obligations.

### **Main Principle C.2 – INTERNAL CONTROL**

**The Board should maintain a sound system of internal control to safeguard shareholders' investment and the company assets**

**All directors are culpable in relation to both the Reading Incident and issues relating to distress and impairment.**

The **Turnbull Guidance** suggests means of applying this part of the Combined Code. This is discussed below.

Under Code Provision C.2.1, a company's Board had to report in its Financial Statements (i.e. "at least annually" "and should report to shareholders that they had done so") that they have conducted a review of the effectiveness of the system of internal controls. The review should cover

## The Combined Code on Corporate Governance (2006)

The Combined Code sets out standards of good practice in relation to various aspects of Corporate Governance

More specifically, the Combined Code as a governance framework contains broad principles and more detailed provisions that companies may wish to help them discharge their duties and responsibilities to the best interests of their shareholders. The Code is principles based and not a rigid set of rules.

### Disclosure is a key part of a principles based approach to governance

The listing rules require listed companies to make a disclosure statement in two parts in relation to the Combined Code. In the first part of the statement, a company has to report on how it applies the principles in the Combined Code. In the second part of the statement, a company has either to confirm that it complies with the Combined Code's provisions or where it does not to provide an explanation (The 'comply or explain' requirement).

This 'comply or explain' mechanism is an integral part of the Combined Code and as at the time of corporate governance since the Cadbury Report was issued in 1992, was designed to give shareholders a clear and comprehensive picture of a company's corporate governance arrangements in relation to the Code.

In practical terms, if a company does not comply with any of the provisions of the Combined Code, it must state the reasons for non-compliance. The policy of non-compliance and the steps it is taking or has taken to ensure full compliance in the future.

Where there are dissenting

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Disclosure is a key part of a principles based governance framework.

The Listing Rules require listed companies to make a disclosure statement in two parts in relation to the Combined Code. In the first part of the statement, a company has to report on how it applies the principles in the Combined Code. In the second part of the statement a company has either to confirm that it complies with the Combined Code's provisions or where it does not, to provide an explanation. (The 'explain or explain' requirement)

This 'explain or explain' mechanism is an integral part of the Combined Code and is at the heart of corporate governance since the Cadbury Report was issued in 1991. It was designed to give shareholders a clear and comprehensive picture of a company's corporate governance arrangements in relation to the Code.

In practical terms, if a company does not comply with any of the provisions of the Combined Code it must state the reasons for non-compliance, the period of non-compliance and the steps it is taking or has taken to ensure full compliance in the future.

Where there are departures from the Combined Code's provisions, the Listing Rules require effective engagement with shareholders and investors so that the disclosures around non-compliance with specific Code provisions should not come as a surprise.

Schedule 6 of the Combined Code includes specific requirements for disclosure within the Annual Report, including a report that the Board has conducted a review of the effectiveness of the group's system of internal controls (C.2.3).

Whilst recognising the obligation to announce, the Disclosure and Transparency Rules do allow an announcement to be delayed if the delay is not so as to prejudice the legitimate interests of the company, as long as the public will not be misled and the company can ensure the information remains confidential. It is perfectly reasonable to delay an announcement if there is a need to clarify a situation but in the spirit of Listing Principle 4, if a company is unwilling or unable to make an announcement then suspension of trading may be appropriate.

Disclosure and Transparency Rule 2.5.2 provides guidance including that investors understand that some information must be kept confidential until developments are at a stage when an announcement can be made without prejudicing the legitimate interests of the company.

Other sanctions for breaches relating to the disclosure of information to the market, that may be imposed by the FSA are public censure or fines imposed on any director who was knowingly concerned in the breach.

**The Reading Incident was significant in terms of the size of the identified impairment, the weaknesses in the firm's internal controls, senior responsibility and culpability, reputational risk and the risks of litigation and sanction.**



## The UK Listing Rules and Principles, and the Disclosure and Transparency Rules

The Disclosure and Transparency Rules contain provisions relating to the obligations to make announcements to the Stock Exchange. In this regard an issuer (company) must notify a Regulatory Information Service (Stock Exchange) as soon as possible of any inside information, which directly concerns the issuer.

In this regard the test is:

- Whether the information is likely to be used by a reasonable investor as part of the basis of his investment decisions; and
- Would therefore be likely to have a significant effect on the price of the company's shares.

In assessing materiality, FSA /UKLA guidance is that it is not possible to reduce "the significant effect" requirement to a fixed percentage (i.e. no 10% or 5% rule), and the significance of any likely price change will vary from issuer to issuer. This in turn will depend on the market's attitude to the issuer, the circumstances and the sector of the issuer.

Shares of financial services companies in the UK became highly volatile from Summer 2007. On 19 March 2008, HBOS shares were shorted. In the second half of 2007 Northern Rock and Barclays also experienced "trash and cash" events. There is no doubt whatsoever that disclosure of the Reading Incident would have had a significant effect on the HBOS share price.

The Listing Principles ensure that listed companies pay due regard to the fundamental role they play in maintaining market confidence and ensuring fair and orderly markets. The Listing Principles assist listed companies in identifying their obligations and responsibilities under the Listing Rules.

Listing Principle 2 encompasses the need for adequate procedures, systems and controls in relation to the timely and accurate disclosure of information to the Stock market. Timely and accurate disclosure of information to the market is a key obligation of listed companies.

Listing Principle 3 provides

*A listed company must act with integrity towards holders and potential holders of its listed equity securities.*

And Listing Principle 4 provides

*A listed company must communicate information to holders and potential holders of its listed equity securities (shares) in such a way as to avoid the creation or continuation of a false market in such listed equity securities.*

### Measure of Compensation

Section 90 provides that a defendant is liable to compensate the claimant for loss he has suffered in respect of the securities as a result of the misstatement or omission. However, FSMA does not outline the measure of damages, nor is it the subject of any direct authority. There is much debate on whether the appropriate measure is that in the tort of deceit (which would enable recovery of all losses which have flowed naturally from acquiring the securities) or the tort of negligent misstatement (which would confine damages to the consequences of the statement being false or misleading).

### Issuer Liability Rules

Section 90A of FSMA, which came into force on 20 January 2007, carries a fraud test but it imposes liability on the issuer and not the directors (or anyone else), except for liability to the issuer.

Under section 90A of FSMA, an issuer is liable to compensate a shareholder who has acquired securities and suffered loss as a result of an untrue or misleading statement in a report required by the DTR 4 or an omission from such a report (or preliminary statement to the extent it contains the same information). However, the issuer is only liable if a director:

- Knew or was reckless as to whether it was untrue or misleading;
- Knew the omission to be a dishonest concealment of a material fact.

The exemption from liability does not extend to civil penalties or criminal offences.

### Information requirements

Under FSMA Prospectuses must contain all information that investors and their advisers reasonably require, and would reasonably expect, for the purposes of making an informed assessment of: the assets and liabilities, financial position, profits and losses, and prospects of the issuer of the securities; and the rights attaching to those securities. This is in addition to any other specific information required by the relevant Listing Rules or the FSA.

FSMA further provides that an issuer must publish supplementary listing particulars or a supplementary Prospectus in circumstances where there is a "significant change affecting any matter" contained in the listing particulars or Prospectus or where a "significant new matter arises".

### Persons responsible may include:

- The issuer of the securities i.e. the company;
- Each director at the time that the Prospectus was published;
- Any person who accepts, and is stated in the listing particulars or Prospectus as accepting, responsibility for the contents;
- Any person not falling within any of the categories above who has authorised the contents. Professional advisers, such as investment banks and accountancy firms, may fall within this latter category, but will not be "responsible" for the listing particulars or Prospectus if they have simply given advice as to its contents.

### Potential claimants

A claimant who has acquired or contracted to acquire securities need only demonstrate that he has suffered loss as a result of the misstatement or omission. He does not need to show that he relied on the misstatement in the listing particulars or Prospectus in making the acquisition, it is sufficient that the market price was affected and led to the claimant suffering a loss.

This is functionally equivalent to the "fraud on the market" doctrine in US securities law. The fraud on the market doctrine assumes that where securities are traded in an efficient market, all public information is reflected in the market price. The US courts will therefore presume that a claimant relied on the alleged material misstatements or omissions when making the decision to trade in the securities.

Section 90 is also considered to extend to after-market buyers (that is, secondary buyers of securities that have already been issued and subsequently traded by the original subscriber).

## DISCLOSURE

### Issuer Liability

Section 90 of the Financial Services and Markets Act 2000 (FSMA) makes any person who is responsible for listing particulars and Prospectuses liable to compensate a person who has:

- Acquired or contracted to acquire securities to which the listing particulars or Prospectus applies; and
- Suffered loss as a result of either:
  - any untrue or misleading statement in the listing particulars or prospectus; or
  - the omission from the listing particulars or Prospectus of any matters required to be included by FSMA.

Whether a statement is "untrue" or "misleading" is a question of fact, which will be judged objectively. Although FSMA does not make the point explicitly, the time at which the truth or accuracy of the relevant statement is to be tested appears to be the time when the listing particulars or Prospectus is published.

Section 90 does not cover misstatements or omissions in an issuer's periodic financial disclosures (for example, annual and half-yearly reports and accounts), or in information published to the market by means of a recognised information service: these are both subject to the compensation regime in section 90A of FSMA.

**The Prospectus Rules require a prospectus to contain a declaration by the directors of the issuer that to the best of their knowledge, information contained in the Prospectus is in accordance with the facts and contains no omission likely to affect its import.**

There are penalties for knowingly being concerned with a contravention of the Listing and Prospectus Rules, and in particular in relation to section 90.

**Section 397 FSMA additionally makes it a criminal offence for any person who knowingly or recklessly makes a false or misleading statement, promise or forecast, or dishonestly conceals any material fact for the purpose of inducing another person to enter an investment transaction or refrain from doing so**



## DIRECTORS' LIABILITY FOR FINANCIAL STATEMENTS

### Directors' Statutory Duties

The Companies Act 2006 introduced a statutory statement of directors' duties that replaced many existing common law and equitable rules. The general duty was replaced by a duty to act in the way that the director considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole.

Prior to 2007 directors' liability for companies' accounts could arise under:

- The Companies Act 1985 (1985 Act);
- The UK Listing Authority's Listing Rules and FSMA (both civil and criminal liability);
- The general law - misrepresentation, deceit and negligent misstatement (civil liabilities to third parties, plus possible criminal liability);
- Directors' duties owed to the company under the common law.

Liability of directors to persons other than the company may be restricted by the Capro decision in the same manner as it is for Auditors.

The 2006 Act changed the regime and introduced a statutory regime for directors' liability for inaccurate statements or omissions made in the Directors' Report, including the business review, Directors' Remuneration Report and Summary financial statement.

However in respect of these, a director is only liable to compensate the company for any loss suffered as a result of an untrue or misleading statement or an omission of anything required to be in the reports if the director:

- Knew or was reckless as to whether the statement was untrue or misleading; or
- Knew the omission to be dishonest concealment of a material fact.

7. An approved person performing a significant influence function must take reasonable steps to ensure that the business of that firm for which he/she is responsible in his/her controlled function complies with the regulatory requirements imposed on that business.

In considering the Reading Incident and events subsequent to July 2007 in relation to the non disclosure of, and provision of misleading information to shareholders and the market, the standard of conduct that was expected, required and obligated by the approved persons, there has been material breaches of the applicable Principles.

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## APPROVED PERSONS

All members of HBoS' Executive Board and Main Board (the directors) and certain other senior executives were approved persons.

An approved person is an individual who has been approved by the FSA to perform one or more 'controlled functions' on behalf of an authorised firm. The purpose of FSA approval of individuals who perform controlled functions is to ensure that the individuals concerned are 'fit and proper'.

When considering a candidate's fitness and propriety, the FSA considers: (i) honesty, integrity and reputation; (ii) competence and capability; and (iii) financial soundness. The approval of individuals complements FSA regulation of the authorised firm for which the approved person performs the function.

FSA approval to perform a controlled function brings with it a number of important responsibilities, including a duty to be aware of and comply with FSA regulatory requirements and expectations. Specifically, approved persons must comply with the Statements of Principle and the Code of Practice for Approved Persons. These Statements of Principle describe the conduct that the FSA requires and expects of the individuals it approves. Four Statements of Principle apply to all approved persons and three apply to persons who carry out a significant influence function. The Code of Practice sets out guidance, together with generic examples of conduct which, in the FSA's opinion, does not comply with the Principles.

Non compliance with these regulatory requirements could result in the FSA taking enforcement action against the approved person.

The Principles for approved persons mirror those that apply to the authorised firm:

### The FSA Principles for Approved Persons

- 1 An approved person must act with integrity in carrying out his/her controlled function.
- 2 An approved person must act with due Skill, Care and Dillgence in carrying out his/her controlled function.
- 3 An approved person must observe proper standards of market conduct in carrying out his/her controlled function.
- 4 An approved person must deal with the FSA and with other regulators in an open and co-operative way and must disclose appropriately any information of which the FSA would reasonably expect notice.
- 5 An approved person performing a significant influence function must take reasonable steps to ensure that the regulated business of the firm for which he/she is responsible in his/her controlled function is organised so that it can be controlled effectively
- 6 An approved person performing a significant influence function must exercise due skill, care and diligence in managing the business of that firm for which he/she is responsible in his/her controlled function.

### **Inaccurate, false or misleading information**

Rule 15.6.1 states that a firm must take reasonable steps to ensure that all information it gives to the FSA in accordance with a rule in any part of the Handbook (including Principle 11), is; (1) factually accurate or, in the case of estimates and judgments, fairly and properly based after appropriate enquiries have been made by the firm; and (2) complete, in that it should include anything of which the FSA would reasonably expect notice.

If a firm becomes aware of, or receives information to the effect that it has or may have provided the FSA with false, misleading, incomplete or inaccurate information, it must notify the FSA immediately. This notification must include details of the information which is incorrect, an explanation why such information was provided and the correct information. If it is not possible to submit the correct information at that time, it must be submitted as soon afterwards as possible. It is worth noting that section 398 FSMA makes it an offence for a firm to knowingly or recklessly provide the FSA with information which was false or misleading in a material particular in purported compliance with the FSA's rules or any other requirement imposed by or under the Act.

### **Failure to Notify**

Failure to notify altogether or even a delay in notification will amount to a regulatory breach and as such disciplinary action could be taken by the FSA. Failure to notify not only constitutes a breach of one or more rules in Chapter 15, but also invites investigation as to whether or not a firm is conducting itself using inadequate arrangements, systems and controls. In addition, the FSA will be interested in the apportionment and oversight of the controlled function for which notification to the FSA is responsible.

**In considering the Reading Incident and events subsequent to July 2007 in relation to (1) the non disclosure of, and provision of misleading information to shareholders and the market and (2) the standard of conduct that was expected, required and obligated under the Principles for Business; there has been material and fundamental non compliance by HBOs.**



### **Matters having a serious regulatory impact**

Rule 15.3.1 states that a firm must notify the FSA immediately if it becomes aware, or has information which reasonably suggests, that any of four situations has occurred, may have occurred or may occur in the foreseeable future. These include:

- Any matter which could have a significant adverse impact on the firm's reputation;
- Any matter in respect of the firm which could result in serious financial consequences to the financial system or to other firms.

Immediate notification means that a firm should notify its usual supervisory contact at the FSA by telephone or by other prompt means of communication, before submitting a written notification.

### **Fraud, errors and other irregularities Rule 15.3.17**

This rule states that a firm must notify the FSA immediately if one of the following events arises and the event is significant:

- (1) It becomes aware that an employee may have committed a fraud against one of its customers; or
- (2) It becomes aware that a person, whether or not employed by it, may have committed a fraud against it; or
- (3) It considers that any person, whether or not employed by it, is acting with intent to commit a fraud against it; or
- (4) It identifies irregularities in its accounting or other records, whether or not there is evidence of fraud; or
- (5) It suspects that one of its employees may be guilty of serious misconduct concerning its honesty or integrity and which is connected with the firm's regulated activities or ancillary activities.

Whether or not a matter is significant is dependant upon the size of any monetary loss, the risk of reputational loss to the firm and whether the incident reflects weaknesses in the firm's internal controls.

7. **Communications with clients** - A firm must pay due regard to the information needs of its clients and communicate information to them in a way which is clear, fair and not misleading
8. **Conflicts of interest** - A firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client.
9. **Customers: relationships of trust** - A firm must take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely upon its judgement.
10. **Clients' assets** - A firm must arrange adequate protection for clients' assets when it is responsible for them
11. **Relations with regulators** - A firm must deal with its regulators in an open and co-operative way and must disclose to the FSA anything relating to the firm of which the FSA would reasonably expect notice

Breaching a Principle makes a firm liable to disciplinary sanctions. The Principles are also relevant to the FSA's powers of investigation and intervention. (Note: The Principles do not give rise to actions for damages by a private person.)

#### **Principle 11: Communication with the FSA**

Principle 11 dictates that "A firm must deal with its regulators in an open and co-operative way, and must disclose to the FSA appropriately anything relating to the firm of which the FSA would reasonably expect notice."

[The notification requirements of the FSA are set out in Chapter 15 of the Supervision Manual of the FSA Handbook.]

Communication with the FSA in accordance with Principle 11 includes:

- Any significant failure in the firm's systems or controls, including those reported to the firm by the firm's Auditor;
- Any action which the firm proposes to take which would result in a material change in its capital adequacy or solvency.

The timescale for notice under Principle 11 is very much dependent upon the event, although the FSA expects the firm to discuss relevant matters with it at an early stage, before making any internal or external commitments. Notification under Principle 11 may be given orally or in writing, although the FSA may request written confirmation of a matter.

## The FSA's PRINCIPLES OF BUSINESS AND PRINCIPLES FOR APPROVED PERSONS

HBoS and its directors materially and fundamentally breached the majority of all Principles with regard to the Reading Incident and events subsequent to July 2007.

The Financial Services and Markets Act 2000 (FSMA) gave the FSA four statutory objectives

- 1 **Market confidence:** maintaining confidence in the financial system;
- 2 **Public awareness:** promoting public understanding of the financial system;
- 3 **Consumer protection:** securing the appropriate degree of protection for consumers; and
- 4 **The reduction of financial crime:** reducing the extent to which it is possible for a business to be used for a purpose connected with financial crime.

These objectives are supported by a set of principles of good regulation, which the FSA was compelled to have regard to when discharging their functions.

The FSMA empowered the FSA with sufficient authority for it to regulate the financial services industry.

### PRINCIPLES FOR BUSINESS

The Principles for Business are contained within the FSA's four statutory objectives. There are 11 Principles, which are general statements of the main regulatory obligations that apply to each authorised firm. The Principles set out in simple terms the high level standards that all firms must meet.

Contravention of one or more Principles of Business results in Enforcement Action.

#### Eleven Principles of Business

1. **Integrity** - A firm must conduct its business with integrity.
2. **Skill, care and diligence** - A firm must conduct its business with due skill, care and diligence.
3. **Management and control** - A firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems.
4. **Financial prudence** - A firm must maintain adequate financial resources.
5. **Market conduct** - A firm must observe proper standards of market conduct.
6. **Customers' interests** - A firm must pay due regard to the interests of its customers and treat them fairly

## SECTION SIX: DIRECTORS' DUTIES AND OBLIGATIONS

This section provides information relating in general to Directors' statutory, regulatory and other duties, with particular regard to areas where there have been material violations, non compliance and breaches. It is provided for awareness purposes to aid a better understanding for those who may not be familiar with the relevant statutes, law and regulation.

Detailed evidence relating to actual or potential breaches and violations is provided elsewhere, where it is most appropriate to report.

### OBLIGATIONS TO SHAREHOLDERS

Under statute and regulation, listed companies are required to disclose certain business and financial information to shareholders and the market at regular intervals. This information should "present a balanced and understandable assessment of the company's position and prospects".

**In particular, the board of directors has a duty to prepare an Annual Report and Accounts, which must be sent to all shareholders. The Accounts (financial statements) must give a true and fair view of the financial position of the company and be subject to audit.**

Under the Combined Code on Corporate Governance, companies must also disclose corporate governance arrangements, which include a description of the main features of the internal control and risk management systems in relation to financial reporting.

Although there are no explicit obligations resting on companies to disclose the occurrence of fraud to shareholders and the market, companies must notify a Regulatory Information Service (i.e. the Stock Exchange and Listing Authority) as soon as possible about any inside information which directly concerns it which would be used by a reasonable investor as part of the basis of their investment decision and therefore is likely to have a significant effect on the price of the company's shares if made generally available. This could include significant and/or material frauds. The FSA under its statutory obligations will provide counsel on the balance that may need to be struck between ensuring shareholders receive accurate financial information about the company and the risk of reporting a corporate fraud too soon, before the circumstances of the fraud have been fully investigated.

**Companies "must communicate information to holders and potential holders of its listed equity securities in such a way as to avoid the creation or continuation of a false market in such listed equity securities." Accordingly, publication of misleading, false or deceptive information is prohibited and a company must take all reasonable care to ensure that any notifications made to a RIS are accurate and complete.**



# SECTION SIX: DIRECTORS' DUTIES AND OBLIGATIONS

### **Affect on Financial Statements**

The circumstances that give rise to a right or duty to report may involve an uncertainty on matters which require disclosure in the financial statements. Accordingly the Auditor must consider whether in the light of a right or duty to report, the disclosures in the financial statements are adequate for the purposes of giving a true and fair view.

There is also the case where there are consequential affects on the Audit Opinion and / or any subsequent financial statements.

### **THE FCA'S REVIEW INTO THE COLLAPSE OF HBOS**

The recent Parliamentary Commission's Fourth Report relating to the Failure of HBOS was based on work conducted as part of the Commission's consideration of banking standards and culture, to form part of the Commission's Final Report. However given the seriousness of the issues raised and to shape the agenda for the FSA's forthcoming report following criticism by the Treasury Select Committee of the FSA report on RBS, it was decided to report separately on the failure of HBOS. The terms of reference for the Panel's review therefore directly reflected the overall remit of the Parliamentary Commission on Banking Standards.

The Treasury Commission panel who reported on the failure of HBOS required the FSA to carry out a comprehensive assessment to expand on themes identified by the Commission's work. Specific requirements relating to matters to be included in the scope of the FSA's review were conveyed to the FSA, and are set out in the Commission's Report. These mainly relate to the FSA's conduct.

The FSA's Summary Board Minutes of 5 September 2012, discuss the approval of a paper proposing the scope of the FSA's review of HBOS. It was agreed that to the extent the review took account of factual input from auditors (KPMG) then the role of the auditors would be considered in that context but the review would not assess the work of the auditors nor seek to opine on the relevant accounting standards and their application (on the basis that the FCA does not regulate auditors).

The FRC has indicated that it will consider investigating the role of KPMG as Auditors of HBOS once the PRA's report into the failure of HBOS is available. Under the FRC's powers it will launch an investigation if there is evidence to suggest that the financial statements were misleading, and there were deficiencies in the audit. Surprisingly until the PRA's report is made available, the FRC have stood by the statement made to the Treasury Select Committee in 2009, that the FRC's enquiries had not shown evidence of Audit failure.

Of concern in this is that the conduct of KPMG as Auditors was out of scope of the FSA/PRA's inquiry. This is quite right given in this respect the FRC are the correct regulating authority. The dependency then on the PRA to provide preliminary evidence of misconduct or failings by KPMG, would appear a false premise to make. It would appear that there is a significant under-lap ambiguity.

In assessing materiality, a matter is of material significance to a regulator's functions, when due to either its nature or potential financial impact, it is likely of itself to require investigation by the regulator.

Where an Auditor concludes that a matter does give rise to a statutory duty to make a report then it must be done as soon as practicable in a form and manner which will facilitate appropriate action by the regulator.

Where the matter is one that casts doubt on the integrity of those being charged with governance or their competence to conduct the business of the regulated firm, the Auditor must report without informing those in governance in advance.

The precise nature of matters that give rise to a statutory duty to report vary. In general however, such a duty arises when the Auditor becomes aware that:

- The regulated entity is in serious breach of:
  - Requirements to maintain adequate financial resources; or
  - Requirements for those charged with governance to conduct its business in a sound and prudent manner.
- There are circumstances which give reason to doubt the status of those charged with governance or senior management as fit and proper persons.

Where a statutory duty to report arises the Auditor is required to report regardless of whether the matter has been referred to the regulator by other parties including the company or those charged with governance, and regardless of any duty owed to other parties, including the shareholders.

#### **Auditor's Right to Report**

Where a matter does not give rise to a statutory duty to report but nevertheless may be relevant to the regulator's exercise of its functions, the Auditor still has a right to report direct.

In such instances the Auditor advises those charged with governance that in the Auditor's opinion that the relevant matter should be drawn to the regulator's attention. Where those charged with governance do not properly inform the regulator within a reasonable period then the Auditor must report direct to the regulator as soon as practicable.

appropriate enquiries have been made by the firm; and (2) complete, in that it should include anything of which the FSA would reasonably expect notice.

**If a firm becomes aware of, or receives information to the effect that it has or may have provided the FSA with false, misleading, incomplete or inaccurate information, it must notify the FSA immediately.**

This notification must include details of the information which is incorrect, an explanation why such information was provided and the correct information. If it is not possible to submit the correct information at that time, it must be submitted as soon afterwards as possible. It is worth noting that section 398 FSMA makes it an offence for a firm to knowingly or recklessly provide the FSA with information which was false or misleading in a material particular in purported compliance with the FSA's rules or any other requirement imposed by or under the Act.

#### **Failure to Notify**

Failure to notify altogether or even a delay in notification will amount to a regulatory breach and as such disciplinary action could be taken by the FSA. Failure to notify not only constitutes a breach of one or more rules in Chapter 15, but also invites investigation as to whether or not a firm is conducting itself using inadequate arrangements, systems and controls. In addition, the FSA will be interested in the apportionment and oversight of the controlled function for which notification to the FSA is responsible.

#### **AUDITORS' RIGHT AND DUTIES TO REPORT DIRECT TO THE FSA**

**KPMG aligned themselves with HBoS and lost independence.**

#### **Auditors' Statutory Duty to Report Direct**

Under their risk-based approach to supervision, the FSA relied heavily on the audit profession for the provision of audited financial information or other information that comes to the auditor's attention in the normal course of their audit work.

Auditors have a duty to report direct to the FSA under the FSMA on matters that may be of material significance to the FSA in relation to the company being audited.



## MONEY LAUNDERING SUSPICIONS

Strong evidence of money laundering became apparent in early 2007 yet no **Suspicious Activity Reports** have ever been raised, suspicions have not been reported to the Serious Organised Crime Agency and have not been reported to the FSA, by HBoS, KPMG or the relevant investigating accountants and Insolvency Practitioners.

Deloitte should have identified evidence of highly suspicious transactions strongly indicative of money laundering in course of the s166 investigation.

The Reading Incident was reported to the FSA in March 2007 and the FSA was later given a copy of the July 2007 Group Credit Report. However the Reading Incident was reported as being a control issue relating to a single employee. **The FSA was deliberately misled.**

Preventing financial sector firms being used for a purpose connected with financial crime is one of the FSA's four statutory objectives. The FSA take this objective extremely seriously. They consider detection and prevention of financial crime as being a board level issue. Financial crime, including money laundering has been identified as one of the major threats to confidence in UK markets. Maintaining confidence in the financial system is also one of the FSA's statutory objectives.

If suspicions of money laundering and the true extent of the Reading Incident had been properly reported to the FSA in 2007 then it is unlikely that the FSA would have approved the Basel II Advanced IRB Approach for credit risk capital.

## PROVISION OF INACCURATE, FALSE OR MISLEADING INFORMATION TO THE FSA

- Senior executives and directors of HBoS and KPMG have committed serious criminal offences under the Financial Services and Markets Act 2000.
- It is a criminal offence to knowingly provide information to the FSA, which is false or misleading in respect of an issue that is not immaterial. Concealing or failing to disclose important information, is deemed to be misleading.
- HBoS continued to deliberately mislead the FSA in relation to impairment, loss, capital adequacy and the Reading Incident, for an extended period. KPMG is complicit.

A number of offences under s398 have been committed relating to the non disclosure of the Reading Incident to the FSA including the misreporting of the situation, and the non disclosure of other essential information, affecting the Rights Issue and the acquisition by Lloyds TSB.

Rule 15.6.1 states that a firm must take reasonable steps to ensure that all information it gives to the FSA in accordance with a rule in any part of the Handbook (including Principle 11), is; (1) factually accurate or, in the case of estimates and judgments, fairly and properly based after

### 2007/8 ARROW Risk Assessment

The FSA issued their ARROW Letter on 22 April 2008 (Draft in March 2008). The on-site work had been conducted in November and December 2007.

Despite approving the Advanced IRB approach waiver the FSA were clearly concerned about the risks the Corporate models presented. *"The potential impact of a serious failure in the calculation of Regulatory Capital is severe."*

Whilst appreciating the normal scope of an ARROW assessment, it is difficult to understand that in carrying out a full ARROW assessment during November and December 2007, when the syndication and securitisation markets were closed, the wholesale markets had tightened, the financial crisis was deepening and given the FSA's concerns in relation to the high risk nature of Corporate's portfolio, the FSA did not make due inquiry as to distress, valuations and credit risk relating to that portfolio.

In relation to Provisioning, the FSA relied on a review conducted by Group Risk and KPMG. The Reading Incident had been investigated during 2007 and by the end of the year significant Provisions had been raised, and subject to audit by KPMG. In this regard it must be concluded that Group Risk and KPMG deliberately misled the FSA.

The ARROW letter does comment that in relation to syndicated and leveraged loans, the FSA would be reviewing those portfolios and their impact on the capital position. Either that review had not been undertaken by 19 June 2008 or the FSA did not act on the findings prior to the publishing of the Rights Issue Prospectus on 19 June 2008.

The ARROW letter also comments that the FSA would be heavily monitoring credit risk and provisioning in view of HBOs' substantial exposure to the risks of a UK downturn. Again it has to be questioned what monitoring was undertaken prior to the Rights Issue Prospectus being published.

ARROW letters and RMPs are required by Auditors. There are many issues raised in the April 2008 ARROW letter and RMP. It is extremely concerning that KPMG chose to continue their stance of not complying with their reporting obligations to the FSA.

It should be noted that throughout 2008 KPMG were heavily involved at HBOs given their role as Auditors and Reporting Accountants, and in view of the deepening financial crisis and its affects on HBOs. They were in regular receipt of the monthly CRC reports and were in close contact with senior executives.

## DUTY TO REPORT TO THE FSA

Those charged with governance chose not to report truthfully to the FSA and have condoned suspected money laundering associated with the Reading Incident.

HBoS did not report suspected money laundering offences or fraud to the FSA, despite evidence that was available that gave rise to reasonable suspicion.

Companies in the financial services sector must notify the FSA immediately if one of the following events arises and it is significant:

- 1) It becomes aware that an employee may have committed fraud against one of its customers;
- 2) It identifies irregularities in accounting or other records;
- 3) It suspects one of its employees may be guilty of serious misconduct connected with its regulated or ancillary activities. (HBoS reported item 3 in relation to Lynden Scourfield.)

Whether or not a matter is significant is dependant upon the size of any monetary loss, the risk of reputational loss to the firm and whether the incident reflects weaknesses in the firm's internal controls.

It was impossible for Lynden Scourfield to operate as a "sole rogue banker". There were other HBoS employees involved and there is evidence available to substantiate their suspected criminal involvement.

At the time of Andrew Scott's and David Miller's investigations in 2007, Mark Dobson and Steve Gullon were strongly suspected as having direct involvement together with Lynden Scourfield. Suspicions were not reported on SARs and were not reported to the FSA. They, and others, remained employed by HBoS, they retained their Reading and London portfolios and they remained in key roles in the management of Reading Incident cases, and were able to influence decisions in relation to Reading Incident cases. Mark Dobson was arrested in 2011 and subsequently charged.

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It should be noted that throughout 2008 KPMG were heavily involved at HBOS given their role as



Prior to the Rights Issue Prospectus being published on 19 June 2008, it was evident that the amount of capital that was required was very substantial and in all likelihood HBOS was a gone concern.

## THE ALTERNATIVES

In the circumstances outlined above, it might have been considered by the FSA, if they were consulted, that withholding a Going Concern "qualification" in February 2008 was in the interests of the shareholders. If the FSA deemed otherwise then the post Lehman Armageddon would have happened in early 2008.

However the irrefutable evidence of Reading would have given no alternative but the necessity for a Going Concern "qualification" given, the materiality of the impairment, the possibility of customer compensation, reputational risk and the fundamental breakdown in internal controls. All of which required disclosure.

### In summary:

- Suspicious Activity Reports should have been raised by March 2007;
- Correct disclosure should have been made to the FSA in March 2007;
- There should have been a Stock Exchange announcement in July 2007;
- There should have been disclosure in the 2007 Interim Results, in which event the directors could not make a Going Concern statement;
- It should have been disclosed as an Exceptional Item in the 2007 Annual Report and Accounts;
- The Corporate Governance Statement should have had disclosure;
- Contingent Liability disclosures might have been necessary to cover potential litigation and fines;

### THUS

- KPMG would have no alternative but to give a Going Concern emphasis of matter statement or qualification in the 2007 Annual Report and Accounts.

## SECTION SEVEN: AUDIT AND AUDITORS

1. The following information was provided by Sally Masterton in her interview on 10<sup>th</sup> and 11<sup>th</sup> July 2013.

2. Sally Masterton advised that she was not involved in the audit of the accounts of the Lord Turnbull Group for the year ended 31<sup>st</sup> December 2012.

3. Sally Masterton advised that she was not involved in the audit of the accounts of the Lord Turnbull Group for the year ended 31<sup>st</sup> December 2011.

4. Sally Masterton advised that she was not involved in the audit of the accounts of the Lord Turnbull Group for the year ended 31<sup>st</sup> December 2010.

5. Sally Masterton advised that she was not involved in the audit of the accounts of the Lord Turnbull Group for the year ended 31<sup>st</sup> December 2009.

6. Sally Masterton advised that she was not involved in the audit of the accounts of the Lord Turnbull Group for the year ended 31<sup>st</sup> December 2008.

7. Sally Masterton advised that she was not involved in the audit of the accounts of the Lord Turnbull Group for the year ended 31<sup>st</sup> December 2007.

8. Sally Masterton advised that she was not involved in the audit of the accounts of the Lord Turnbull Group for the year ended 31<sup>st</sup> December 2006.

9. Sally Masterton advised that she was not involved in the audit of the accounts of the Lord Turnbull Group for the year ended 31<sup>st</sup> December 2005.

10. Sally Masterton advised that she was not involved in the audit of the accounts of the Lord Turnbull Group for the year ended 31<sup>st</sup> December 2004.

11. Sally Masterton advised that she was not involved in the audit of the accounts of the Lord Turnbull Group for the year ended 31<sup>st</sup> December 2003.

## SECTION SEVEN: AUDIT AND AUDITORS

**Note:** KPMG and its material failings and misconduct are considered in more detail in Sections Eight and Nine.

KPMG have over a sustained period not acted with integrity, objectivity and independence. KPMG have adopted a position intrinsically aligned to that of the directors in serious breach of material regulatory and statutory matters, and with persistent and deliberate disregard of professional standards.

An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement whether caused by fraud or error.

The Auditor's primary role is to provide an opinion to shareholders on the information provided by a company's directors in its financial statements.

To form an opinion on the financial statements the Auditor has to first conclude on a number of matters including:

- **Whether the financial statements, including the related notes, give a true and fair view.**

To do this the audit involves evaluating various issues, including:

- **Whether the financial statements provide adequate disclosures to enable the intended users to understand the effect of material transactions and events on the information conveyed in the financial statements.**

**To provide a true and fair view, financial statements must contain both critical and adequate disclosure.**

## THE FRAMEWORK

The purpose of audits is to provide greater confidence in information provided by directors through a professional independent opinion on its truth and fairness.

An Auditor's work is conducted under a framework of professional standards, covering auditing, ethics and financial reporting, and of legislation and regulation.

Bank audits are extremely complicated and require specialised knowledge and a high degree of technical ability. Knowledge is required of FSMA, The Listing Rules, The Disclosure and Transparency Rules and the FSA's rules and guidance as contained in its Handbook. It is unrealistic to expect members of an entire audit team to have detailed knowledge of the FSA's Handbook in particular, however any individual team member's role must be sufficient in the context of that role to enable them to identify situations, which may give reasonable cause to believe that a matter of which they become aware should be reported to the FSA.

FSMA makes provision for the right and duty of Auditors to report directly to the FSA in certain circumstances. This is considered on page 53.

Auditors play an important role in financial markets, promoting confidence in financial information provided by banks and other financial institutions.

The directors of banks are ultimately responsible for the information they present in annual reports, and for the information on which Auditors report. This is an important point as the Auditor's responsibility for auditing only extends to information contained in the financial statements,



summary information taken from the financial statements and the Directors' Remuneration Report that is described as having been audited

In relation to other information in the Directors' Report, Auditors are required to review it and check it is consistent with the financial statements

## THE CORPORATE GOVERNANCE STATEMENT

Auditors are also required under the Listing Rules to review the Corporate Governance Statement and consider whether it reflects the company's compliance with the nine provisions of the 2006 Combined Code, and to report if does not.

In addition to specific auditing requirements in relation to the director's Corporate Governance Statement, the Listing Rules of the FSA require listed companies to ensure that their Auditor reviews each of the following statements required by the Listing Rules, before the Annual Report is published

- The directors' statement in relation to Going Concern,
- The parts of the statement by the directors that relate to the following provisions of the Combined Code
  - C1.1: The directors should explain their responsibility for preparing the financial statements and there should be a statement about their reporting responsibilities;
  - C2.1: The Board should conduct a review of the effectiveness of the group's system of internal controls, and
  - C3.1 to C3.7: Various matters relating to Audit Committees and Auditors

If, based on its review, the Auditor disagrees with the statement by the directors on Going Concern or concludes that the Corporate Governance Statement does not appropriately reflect the company's compliance with the nine provisions of the Combined Code the Auditor reports that under the heading "Other matter" in his audit report.

However, the Auditor is not required to consider whether the directors' statements on internal control cover all risks and controls, or form an opinion on the effectiveness of the group's corporate governance procedures or its risk and control procedures.

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## AUDITING STANDARDS

Auditing Standards address basic principles, core aspects, essential procedures and requirements relating to the audit of financial statements and the Auditor. Certain Auditing Standards establish requirements in relation to specific areas of an Auditor's work, where it is particularly important that the views of Auditors and users of financial statements are aligned. The relevant Standard in relation to audit scope, identifies three areas as examples.

All three are pertinent to the Reading Incident:

- Going concern;
- The Auditor's responsibility to consider fraud in an audit of financial statements; and
- Consideration of laws and regulations in an audit of financial statements.

## THE AUDIT OF BANKS

Auditors of banks are required to be aware of the specific regulatory requirements, including capital adequacy requirements, that apply to banks.

The Auditing Practices Board published Practice Note 19 relating to The Audit of Banks in the UK. It was prepared with assistance and advice from the FSA. Practice Notes are issued to assist auditors in applying auditing standards of general application to particular circumstances and industries. Practice Notes are persuasive rather than prescriptive but they are indicative of good practice and as such it would be highly unusual, particularly for the more technical subjects, for an Auditor to depart from the guidance. In 2004 the APB updated its PNs to reflect International Standards of Auditing and in 2006 PN19 was revised and first released as a consultation draft in May 2006. It is good practice to commence observing the guidance contained in PNs when consultation drafts are issued. PN19 was finalised in January 2007.

It is impossible to audit every transaction and balance that compile the financial statements. Additionally certain items are based on subjective judgement. In planning an audit, Auditors therefore take a risk based approach, identifying areas of greatest audit risk and applying audit tests and techniques that provide material coverage, or evidence, of the validity of the financial statements. Numbers generated in financial statements will rely on a company's systems, including their systems of internal control and corporate governance, and will be subject to audit compliance testing to ensure they are operating as documented and intended, and therefore may be relied upon.

The key risks associated with Corporate division were primarily credit risk and market risk.

KPMG provided evidence in relation to their responsibility for specific audit areas from 2006. These were

- Credit quality
- Impairment
- Going concern
- Basel I and II
- Fraud
- Regulation and Supervision
- Internal control and corporate governance

There were a number of pivotal developments in Corporate division from 2006 relative to the above

- Leveraged Finance
- Joint Ventures
- Other growth
- New internal risk ratings system
- Basel II Advanced Status
- "Discovery" of Reading incident
- Financial crisis

## RULES AND STANDARDS OF PROFESSIONAL CONDUCT

Auditors are bound by the Auditing Practices Board ("APB") Ethical Standard, by the ICAEW Code of Ethics and by the International Federation of Accountants Code of Ethics.

The APB Ethical Standard 1 sets out the standards of Integrity, Objectivity and Independence.

Integrity is a pre-requisite for all those who act in the public interest. To that end an auditor is required not to be affected or seen to be affected by conflicts of interest.

Objectivity excludes compromise and gives fair and impartial consideration to all matters that are relevant. The auditor's judgement must not be affected by conflicts of interest.

Independence is freedom from situations and relationships, which make it probable that a reasonable and informed party would conclude that objectivity either is impaired or could be impaired.

Independence underpins the auditor's objectivity and is fundamental to the users of financial statements.

KPMG have over a sustained period not acted with integrity, objectivity and independence. KPMG have adopted a position intrinsically aligned to that of the directors in serious breach of material regulatory and statutory matters, and with persistent and deliberate disregard of professional standards.

APB's Ethical Standard 5 sets out standards relating to the provision of non-audit services to audit clients. In 2009, KPMG was appointed Project Manager of the data room for Deloitte's s166 investigation of the Reading Incident. KPMG had a material interest in the scope, direction and outcome of Deloitte's investigations. KPMG was severely conflicted. KPMG may have frustrated those inquiries and in particular in relation to their own knowledge, culpability and misconduct. KPMG had a material interest in concealing certain information from Deloitte and subsequently Thames Valley Police.

It is surprising that Deloitte did not report any concern to the FSA that KPMG had a material conflict in relation to their role as the investigation Project Manager or what became Project Windsor.



## DISCLOSURE WITHIN FINANCIAL STATEMENTS

### EXCEPTIONAL ITEMS

Materiality is a fundamental concept of auditing. In the context of financial statements and particulars, information is material if its misstatement (which, includes omission), could influence the economic (investment) decisions of users taken on the basis of the financial information.

Under International Financial Reporting Standards, items that are material either because of their size or their nature, which are derived from the ordinary activities of the business are considered as Exceptional Items and their nature and amount must be disclosed in financial statements.

The separate reporting of Exceptional Items helps provide a better picture of a company's underlying performance and the factors that have affected performance

The Specific Impairment Provision relating to the Reading Incident of itself was an Exceptional Item as regards the financial statements, however the materiality margin as regards a reasonable investor would be extremely low given the significant control deficiencies behind the Incident, the consequences for the larger Corporate business and corporate governance, and the money laundering aspects.

### Tolerances

Reporting materiality can be separately or together, quantitative or qualitative. Qualitative disclosure should be thought of in the context of an important disclosure that is omitted from the financial statements, as was the case in relation to the Reading Incident, and as hinted by Peter Hickman.

Materiality is a matter of judgement. When applying a quantitative measure, one of the practised methods is to use a percentage benchmark. In relation to Profit & Loss Account items, one of the percentages that might be used is 5% of net income from continuing operations. As explained above the tolerance of shareholders and investors would be very low, if not zero, in relation to the Reading Incident.

Ignoring the serious qualitative issues that would give rise to zero tolerance, Peter Hickman's incorrect arbitrary 5% is illustrated in the table below. The table also demonstrates the material impact the Reading Incident cases had on Corporate (and Group) Impaired Lending.

Note: In February 2008 the total Impairment Provision relating to the Reading Incident was estimated to be c.£800m (current estimate based on known cases: c.£1bn).

[The calculation of the P&L Impairment Charge is a net movement.]

	2007	2006	2005
	£'m	£'m	£'m
<b>Impairment Charge (P&amp;L)</b>			
Group	2,012	1,742	1,599
Corporate & International	602	429	428
Group Underlying Profit before Tax	5,708	5,537	
Corporate Underlying Profit before Tax	2,320	1,776	
<b>Arbitrary 5%</b>			
Group	285		
Corporate	116		
Group Impaired Gross Lending	10,547	8,759	
Increase in Group Impaired Lending	1,788		
Corporate Impaired Gross Lending	3,165	1,720	
Corporate With No Loss	1,648	557	
Corporate With Loss	1,517	1,163	
Increase in Corporate Impaired Lending	1,445		
Increase in Corporate With No Loss	1,091		
<b>Analysis of Group Impaired Lending</b>			
Up to 3 months	1,552	779	
3 to 6 months	2,993	2,425	
6 months to 1 year	2,150	1,957	
Greater than 1 year	1,613	1,410	
Recoveries	1,840	1,814	
Possession	399	374	
	10,547	8,759	
<b>Analysis of Corporate Impaired Lending</b>			
Up to 3 months	1,033	227	
3 to 6 months	521	171	
6 months to 1 year	645	572	
Greater than 1 year	966	750	
	3,165	1,720	

**Total Impairment of Reading Cases: EST. £1bn**

Note: The above Ageing Analysis shows an increase in under 6 months' Group Impaired Lending of £1.3bn and in Corporate of £1.2bn.

## CONTINGENT LIABILITIES

The external Auditor's duties in relation to litigation and claims extends to the identification and disclosure of litigation and claims involving the entity, which may give rise to a risk of material misstatement. Those that are identified, which may have a material effect of the financial statements are required to be disclosed or accounted for in the financial statements. In this regard there is no difference between actual or potential litigation and claims, what is important is the probability of the liability and its materiality.

There is no requirement to disclose contingent liabilities (pending litigation), which are remote. However contingent liabilities which are either probable or possible must be described (disclosed) in the notes to the financial statements, including an estimate of the potential financial impact.

KPMG should also have assessed the impact of the Reading Incident on the financial statements in relation to any potential financial consequences, and whether there should be disclosure and / or provision in that regard, given it was known that Reading Incident Impairments should have been disclosed as an Exceptional Item. This should have included an evaluation of:

- Potential fines, penalties, censure, damages and litigation;
- Breaches of laws and regulations;
- Adequacy of disclosure.

The impact from this perspective was also significant and adequate disclosure should have been made.



Given the potential adverse impact of capital adequacy concerns on the confidence in a bank, this will have a consequence on the bank operating as a going concern, and the Auditor will therefore need to consider the robustness of a bank's systems and controls for managing capital, liquidity and market risk, and assess the challenges of raising capital.

If any of these are flawed, capital adequacy will be affected.

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## SECTION EIGHT: KPMG

Such has been KPMG's conduct that there is evidence to support conflict of interest, compromise and a lack of audit impartiality.

KPMG have not just been negligent but their direct involvement in a number of material malpractices and violations regarding HBoS is fundamental and exposes them to claims in relation to misconduct, serious dereliction of duty and breach of regulatory and statutory duties.

By February 2008, KPMG:

- Knew that the Reading Incident should be disclosed;
- Knew that disclosure of the Reading Incident was potentially fatal for HBoS;
- Knew that irrespective of Reading, there were serious Going Concern issues attaching to HBoS;
- Knew that impairment and distress had been avoided;
- Knew that Corporate risk rating models were flawed;
- Knew that Stress Testing was flawed;
- Knew that regulatory capital was overstated under Basel I and II;
- Would have sighted Main and Executive Board Minutes and Papers in which solvency, business model and funding gap issues were raised;
- Would have evidenced the changing risk profile of the Corporate portfolio into extremely high value, highly speculative, narrow based deals;
- Ought to have known that there were dysfunctional behaviours, operational risk and distress within the Joint Ventures, Equities and Entrepreneur portfolios;
- Knew the risks attaching to the Commercial and Residential property markets, both of which had been in decline from August 2007;
- Knew that shareholders and investors were being deliberately misled;
- Had no basis on which to give a clean Audit Opinion.

On 19 June 2008 (the date the Rights Issue was published), KPMG ought to have known or knew that there had been a material deterioration in impairment and stress, £4bn would be insufficient, and HBoS was a Gone Concern.

And in December 2008, KPMG knew that Corporate's stressed portfolio was at least £40bn.

## AUDITOR LIABILITY TO THIRD PARTIES

KPMG not only failed to exercise the degree of professional care and skill that was appropriate, but were complicit in the deliberate non disclosure of the Reading Incident, deliberate non recognition of distress and impairment and the deliberate understatement of regulatory capital.

They have also concerned themselves in being party to deliberately misleading the FSA, shareholders and investors.

An external Auditor's liability is to the company and to the shareholders collectively for the purposes of voting at the AGM.

Auditors are liable to third parties where they have constructive knowledge that a third party may intend to rely on the relevant audited financial statements and that the third party may suffer financial loss as a result of the Auditor's negligence.

It is important to emphasise that constructive knowledge must be proven. Auditors do not owe a general duty of care to individual shareholders, or to the public at large, who rely on the audited accounts when making a decision to invest in the company (the Capro case.)

The 2007 Annual Report and Accounts were signed off in contemplation of the Rights Issue and were a material part of the Rights Issue Prospectus. The 2007 Accounts and 30 June 2008 Interim Results were also contained in the November 2008 Open Offer and Placing Prospectuses and Lloyds TSB's Circular.

KPMG will also have been involved in the Update Announcements to shareholders on 19 June 2008 and 3 November 2008. These were contained in Prospectuses in which KPMG were the Reporting Accountants.

KPMG will additionally have been involved in the 12 December 2008 Trading Update and 17 December 2008 Supplementary Prospectus. These were materially misleading. The November CRC report was available by 17 December 2008.

Of further concern is how Lloyds TSB were able to conclude in their Supplementary Prospectus of 17 December 2008, that "The HBoS Trading Update is broadly consistent with the impairment analysis conducted by Lloyds TSB as part of its review process in October 2008."

## CRIMINAL LIABILITY FOR AUDIT REPORT

Under Section 507 of the Companies Act 2006, Auditors are criminally liable if they knowingly or recklessly cause an audit report to include any matter that is materially misleading, false or deceptive.

Although the effective date for Section 507 was 6 April 2008, the provision would have been known by KPMG at the time the 2007 Audit Report was signed on 27 February 2008. The announcement of the Rights Issue was on 29 April 2008 and the 2007 Annual Report and Accounts contained the latest financial statements, which formed part of the Prospectus. KPMG were the Reporting Accountants.

The Rights Issue Prospectus also formed a material part of the Lloyds TSB Circular and the HBoS and Lloyds TSB Prospectuses relating to the acquisition of HBoS, and again the latest audited information that was available were the 2007 financial statements. KPMG acted as Reporting Accountants in relation to HBoS' Open Offer and Placing Prospectus in connection with the acquisition by Lloyds TSB.

Confidence in the capital adequacy framework and KPMG's Going Concern opinion were key considerations of HBoS' shareholders and users of their financial statements. None more so was this relevant than in relation to the 2008 Rights Issue.

The FSA approved the Advanced IRB Approach waiver on a highly conditional basis in relation to Corporate. In fact in an ideal world the FSA would not have approved the waiver as Corporate did not have reliable models or data. KPMG would be fully aware of the situation.

KPMG would similarly be aware of the import shareholders and users of the financial statements would attach to Corporate Governance and knowledge of the Reading Incident.

KPMG were aware of the Rights Issue prior to signing the 2007 Audit Opinion in February 2008. This should not have caused the audit to be more or less diligent. However KPMG would fully understand the import attaching to their Audit Opinion in this regard and later in relation to the Government assisted takeover by Lloyds TSB.

The Lloyds TSB shareholders would have attached great import to knowledge relating to the Corporate stressed portfolio, which was c.£40bn as at 30 November 2008. Additionally full disclosure of the Reading Incident would have been a critical factor when voting and / or investing.

### Impairment and Distress

**KPMG had a duty to ensure that impairment and distress were not misstated or could otherwise cause misstatement in the financial statements. KPMG failed in that duty and impairment and regulatory capital were significantly and increasingly misstated in the financial statements from the outset.**

The audit risks relating to HBOs' strategy and Corporate's portfolio were obvious. There was a significant risk of misstatement of distress and impairment, and KPMG were required to obtain sufficient audit comfort to mitigate that risk and ensure that the financial statements were true and fair.

KPMG would be aware that under Basel 1 HBOs' deliberate approach to distress and impairment substantially affected retained earnings (profit), Tier 1 capital adequacy ratios and credit quality ratios. This sent distorted signals to shareholders and the market by hiding the true economic substance of corporate activity and the financial position and value of the company.

Under Basel II and the change under the Advanced IRB Approach to use of Expected Loss, HBOs gamed the system through the calculation of their own risk weightings via an internal credit risk rating models that were materially flawed and open to abuse. KPMG had to have known this.

KPMG reviewed Group Credit Risk's reports and relied on their work in relation to credit quality, impairment and distress. It was patently clear that London & South had material connections with material issues, growing drawn, growing DACS, excesses and expired limits. KPMG's audit sampling avoided "mid value" connections generally, and in particular in relation to London & South and Birmingham. The risks and underlap were obvious. Evidence suggests that this may have been deliberate.

In February 2008 the housebuilding industry went into freefall. HBOs was significantly exposed to housebuilders, property development and construction. At the end of February 2008 Crest Nicholson became distressed and in March 2008 formally entered High Risk and Impaired Assets under the direction of David Gibson. Almost immediately afterwards McCarthy & Stone and a number of other significant credits became distressed. During April 2008 referrals from joint ventures, equities, leveraged and entrepreneurs picked up pace. The exposures were massive. The May 2008 CRC report was provided to KPMG. There is considerable evidence to show that KPMG were very closely monitoring HBOs throughout 2008 and regularly received copies of the CRC reports and other information on Impairment and distress.

### **The Reading Incident**

There is evidence to suggest that KPMG was aware of potential irregularities regarding Reading in 2004 and 2005.

In 2007 following the formal discovery of the Reading Incident, KPMG extensively audited Reading Incident cases. They would be aware that significant disclosures were required in the 2007 Annual Report and Accounts. KPMG will also have reviewed Peter Hickman's February 2008 report to the Audit Committee regarding the Reading Incident.

**KPMG would know the effect disclosure of the Reading Incident would have on HBoS.**

### **Annual Report & Accounts: 2006**

There is evidence to suggest that KPMG was aware of financial irregularities relating to the Reading Incident before the 2006 Annual Report and Accounts were announced on 28 February 2007.

If the directors and the FSA still wanted to proceed with the filing, then at that time it would have been known that the Reading Incident would be likely to have a material effect on the financial statements but the effect would not be capable of being quantified. A view would have had to be taken and appropriate counsel sought with regard to the options available. However the obligation to disclose as soon as practicable would remain a continuing obligation.

### **Interim Results: 2007**

**It is however not a grey area when considering the 2007 Interim Results, which were announced on 1 August 2007.**

By that time KPMG and Group Credit Risk had undertaken deep-dive exercises into the Reading Incident. KPMG in particular had assessed Impairment. Additionally, PwC and other Investigating Accountants and Insolvency Practitioners, were involved and PwC in particular had been involved from February 2007.

**The 2007 Interim Results should have made appropriate disclosure of the Reading Incident.**



## THE PROSPECTUS

The directors were knowingly concerned in material contraventions of the Listing Rules, Prospectus Rules, Disclosure Rules, Transparency Rules and Corporate Governance Rules

KPMG were knowingly complicit and were obligated to report appropriately to the FSA

The joint sponsors were not diligent and failed to comply with the duties imposed on them by the Listing and Prospectus Rules

## INFORMATION REQUIREMENTS

Under FSMA Prospectuses must contain all information that investors and their advisers reasonably require, and would reasonably expect, for the purposes of making an informed assessment of the assets and liabilities, financial position, profits and losses, and prospects of the issuer of the securities, and the rights attaching to those securities. This is in addition to any other specific information required by the relevant Listing Rules or the FSA.

FSMA further provides that an issuer must publish supplementary listing particulars or a supplementary Prospectus in circumstances where there is a "significant change affecting any matter" contained in the listing particulars or Prospectus or where a "significant new matter arises"

## REPORTING ACCOUNTANTS: DUE DILIGENCE

KPMG was the Reporting Accountant for the 2008 Rights Issue Prospectus and the November 2008 Open Offer and Placing Prospectus regarding the acquisition by Lloyds TSB (PwC acted as Reporting Accountants for Lloyds TSB )

KPMG as Auditors were responsible for the historical financial information contained in the Prospectuses.

Sponsors are responsible for giving assurance to the FSA that the issuer has met all its relevant regulatory and other obligations.

A Prospectus must contain a statement from each of the persons responsible for it to the effect that, having taken all reasonable care to ensure that such is the case, the information contained in the Prospectus is, to the best of their knowledge, in accordance with the facts and contains no omission likely to affect its import at the date the Prospectus is published.

Persons responsible for the Prospectus risk both civil and criminal liability if the contents of the Prospectus are in any way inaccurate or misleading. For this reason, it is crucial that the company and its advisers carry out adequate due diligence and verify the Prospectus.

Given the speed of deterioration in the market between August 2008 and November 2008, and then through to January 2009, it was incumbent on KPMG and PwC to ensure that the Prospectuses were not misleading, in particular with regard to impairment and distress. The November 2008 Corporate Credit Risk Report clearly reports that the stressed portfolio as at 30 November 2008 was £40bn.

There is a fundamental, general duty of disclosure in relation to Prospectuses:

Under s87A of the FSMA, a Prospectus must contain all such information presented in an easily analysable and comprehensible form which, is necessary to enable investors to make an informed assessment of the assets and liabilities, financial position, profits and losses, and prospects of the company and the rights attaching to the securities.

This obligation forms the basis for the intensive due diligence work that is required to be carried out by the Reporting Accountant. The due diligence requirements can be summarised into the documents that the Reporting Accountant provides under their reporting obligations:

- Long Form Report
- Working Capital Report
- Significant Change Letter
- Capitalisation and Indebtedness

#### **Working Capital Report**

A Prospectus must contain a statement by the issuer that the working capital is sufficient for its present requirements (at least next 12 months' from the date of the Prospectus). It is then a matter for the issuer, its Sponsor and Reporting Accountants to do sufficient underlying work to enable the issuer to be comfortable in making that statement. The Sponsor is required to report to the UKLA that it is satisfied that the directors can make such a statement.

The Working Capital Report is addressed to the directors, company and sponsor.

In relation to what is expected of the Sponsor under the Listing Rules:

'It is important to note that the Sponsor's role is in addition to the part played directly by the directors of the issuer or by a Reporting Accountant appointed by the issuer in the working capital exercise. Specifically the Sponsor must review and challenge the work done by the issuer and the Reporting Accountant and through their own knowledge and experience of the issuer and its operating environment, ensure that the conclusion reached on the issuer's working capital position is the right one under the circumstances.'

The Working Capital Report for the Rights issue has not been sighted but it is difficult to comprehend based on the balance of evidence, how KPMG could provide comfort on sufficiency of working capital on 19 June 2008.

#### Significant Change Comfort Letter

A statement by the issuer is required in the Prospectus that there has been no significant change in respect of the financial or trading position since the last published financial statements (audited) and the date of the financial information contained in the Prospectus, based on the most recent management information. The comfort letter is provided to the Sponsor.

As at 19 June 2008 and 3 November 2008 (the date of the respective Prospectuses), the directors and KPMG knew that there had been significant changes in the financial and trading position of HBoS, and at 19 June 2008 was in all probability a gone concern. They further knew that the 2007 Annual Report and Accounts omitted material disclosures relating to the Reading Incident.

The 17 December 2008 Supplementary Prospectuses of HBoS and Lloyds TSB are both materially misleading in relation to the extent of stress and distress in the HBoS Corporate portfolio.

Section 90 of the Financial Services and Markets Act 2000 (FSMA) makes any person who is responsible for listing particulars and Prospectuses liable to compensate a person who has:

- Acquired or contracted to acquire securities to which the listing particulars or prospectus applies; and
- Suffered loss as a result of either:
  - any untrue or misleading statement in the listing particulars or prospectus; or
  - the omission from the listing particulars or Prospectus of any matters required to be included by FSMA.

Under s.397 FSMA 2000 it is a criminal offence for a person to make a statement, promise or forecast which they know is materially false, misleading or deceptive; dishonestly conceal material facts; or recklessly make a statement, promise or forecast which is materially misleading, false or deceptive in order to induce another person to enter into, or offer to enter into, or refrain from entering or offering to enter into a relevant agreement.

The Fraud Act 2006 became effective on 15 January 2007. It created a new general statutory criminal offence of fraud that can be committed by false representation, by failure to disclose information, or by any abuse of position.

## Auditing Capital Adequacy

On the face of it there was no requirement for KPMG to audit risk weighted assets or credit risk ratings.

Disclosure of capital management and capital adequacy under Basel II was contained in the Group Finance Director's Report on HBO5 and as such did not form part of the Financial statements and as such was technically out of scope. The 2007 Audit Opinion correctly discloses what information has and has not been audited by KPMG.

Capital adequacy is a fundamental consideration in the assessment of Going Concern in relation to a bank.

The key risks associated with Corporate division were primarily credit risk and market risk.

KPMG provided evidence in relation to their responsibility for specific audit areas from 2006. These were:

- Credit quality
- Impairment
- Going concern
- Basel I and II
- Fraud
- Regulation and Supervision
- Internal control and corporate governance

There were a number of pivotal developments in Corporate division from 2006 relative to the above:

- Leveraged Finance
- Joint Ventures
- Other growth
- New internal risk ratings system
- Basel II Advanced Status
- "Discovery" of Reading Incident
- Financial crisis

Drilling KPMG's evidence down:

- 1) In assessing overall credit quality and impairment, KPMG would test HBoS' credit risk rating system, Days Past Due reporting, IAS provisioning modelling and collective provision model, impairment assessment and categorisation, and Specific Impairment Provisions.

In relation to credit quality of the Good Book, which had not been subject to substantive testing then the new internal risk ratings system was fundamental.

Where a new system is introduced that is to be relied on for audit purposes then that system must be subject to robust audit. The new risk rating system, including PD, EL and LGD, which were generated using historic experience of distressed credit, was a critical part of the Corporate models under the Basel II Advanced Internal Ratings Based Approach for credit risk. KPMG would know that the system was flawed.

- 2) The scope of an external audit of the financial statements technically did not cover the RWAs but the scope did cover consideration of the Going Concern concept. As such in considering the Going Concern concept in terms of the 2007 Audit Opinion and thereafter, a fundamental part of that assessment would be capital adequacy ratios, availability of wholesale funding and customer deposits, credit risk and impairment, distress, credit quality, liquidity, regulation, capital and funding requirements and sufficiency; all taken in light of the global financial crisis, which was escalating.

**Accordingly it would be impossible to do this without auditing the Corporate Advanced IRB Approach models including calculations of RWAs, Tier 1 and Tier 2 capital calculations and capital adequacy ratios.**





# SECTION NINE: INSOLVENCY PRACTITIONERS AND INVESTIGATING ACCOUNTANTS

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## SECTION NINE

### INSOLVENCY PRACTITIONERS AND INVESTIGATING ACCOUNTANTS

Firms have breached reporting obligations and have been involved in serious misconduct.

The firms involved include

- PwC
- KPMG
- Hurst Morrison Thomson (now part of Tenon)
- Menzies Corporate Recovery / MCR Corporate Restructuring (now part of Duff & Phelps)

#### SUMMARY

Insolvency Practitioners, investigating accountants and accountants providing other accountancy services, appointed from January 2007, either knew, ought reasonably to have known or should have strongly suspected fraud and/or money laundering offences.

Insolvency Practitioners have additional obligations, which are discussed at the end of this section

- Despite compelling and factual evidence or suspicious evidence of a very serious nature, not one of the Insolvency Practitioners appointed during 2007 and 2008 duly reported to SOCA their suspicions or evidence of director fraud or appointed Liquidators to investigate misfeasance by, or delinquency of, directors.
- It would appear in relation to such persons (David Mills and his associates either as directors or shadow directors) that no adverse reports on the conduct of Directors were submitted to the Insolvency Service.
- There may be repercussions for LBG in that a number of the relevant Insolvency appointments extended into LBG.

### **The Institute of Chartered Accountants in England and Wales: Duty to Report**

Members of the ICAEW have a duty to report to the Institute where public interest requires the reporting of acts of misconduct which, if they were to go unreported could adversely affect the good name of the profession. In this regard the Institute considers it is in the public interest to discipline members whose conduct has fallen short of the high ethical and technical standards expected of members.

The Duty to Report is contained in bye-laws 9.1 and 9.2, and arises when a member is aware of facts or matters, which indicate that a duty to report has arisen. These include circumstances where a member (Chartered Accountant):

- Has committed any offence involving dishonesty, cheating or fraud;
- Has committed any imprisonable offence under Part V of the Criminal Justice Act 1993, FSMA and POCA;
- As a member [partner] of, or employee of a firm been in serious breach of the ICAEW's Audit Regulations;
- As an Insolvency Practitioner committed serious breach of the Insolvency Act or Rules or the ICAEW's Insolvency Licensing Regulations;
- Has been responsible for a serious breach of the Money Laundering Regulations 2003;
- Has committed a serious financial irregularity;
- Has committed a serious breach of faith in a professional respect.

It is important to note that the Duty to Report makes it clear that it is not enough merely to have suspicion.

Circumstances of crime, fraud and other serious misconduct are not protected by the duty of confidentiality.

Any substantial delay in reporting could amount to a failure to report, which of itself constitutes grounds for disciplinary action.

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## THE FIRMS

### HMT and MCR

There is evidence of potential misconduct extending into their relationships with Quayside, David Mills, Lynden Scourfield and Mark Dobson.

### KPMG

There is evidence of potential misconduct relating to Insolvency appointments in and subsequent to 2006. KPMG had a vested interest in their role as external Auditors not coming under scrutiny and challenge.

### PwC

PwC accepted a number of sizeable IBR engagements and Insolvency appointments following the Peer Review, which commenced in January 2007. These included Bradman-Lake, Seoul Nassau and Corporate Jet Services. Not only did PwC not report their actual knowledge or suspicions of serious money laundering but additionally in the case of Corporate Jet Services, they sold assets to former directors when they had cause to suspect the legitimacy of the source of funds used for acquisition.

In relation to the companies to which they were appointed as Receivers or Administrators, no liquidators were appointed to investigate the conduct of directors / shadow directors or take action, and it would appear that no adverse reports into the conduct of David Mills and associates were submitted.

Additionally PwC may have been conflicted in other respects.

A timeline to demonstrate the above in relation to PwC and tying into what was occurring within the High Risk / Impaired Assets and Corporate arenas is set out below. The case being used is Corporate Jet Services. By the time PwC were appointed as Administrative Receivers to Corporate Jet Services in September 2007, their knowledge of the potential money laundering within Corporate Jet Services is likely to have been considerable, as would their actual and suspected knowledge of money laundering within Bradman-Lake, Seoul Nassau and with respect to the Reading Incident overall.

To keep it as simple as possible, the timeline uses only a few suspicious money laundering transactions as examples.

CJS had unauthorised lending in excess of £100m. Outwith Lynden Scourfield, at least five of Scourfield's Reading Team had been or were involved in CJS, and knew that CJS was not being reported properly via Management Information.

For the avoidance of any doubt, the Peer Review team at the very latest were aware of serious potential money laundering regarding CJS, Bradman-Lake, Seoul Nassau, Remnant Media, Clode, David Mills, and a number of other Reading Incident cases on 26 March 2007.

Date	
January 2002	PwC (Rob Birchall) are appointed as Receivers of Chauffair Ltd by HBoS
Summer 2002	To avoid a substantial loss for HBoS (£15m) a deal is negotiated with existing customer Aviation Worldwide Partners plc. Wayne Seymour is a board director and Anthony Shakesby is FD of AWP. Seymour and Shakesby are to be directors of the acquiring vehicle, CJS.
October 2002	Fraud of £13m is alleged against AWP and Seymour. AWP goes into Liquidation.
January 2003	The deal with CJS is negotiated as a standalone. Seymour is not a Board director but is to be CEO. Shakesby remains a director of CJS. David Mills is appointed a director, who has a close relationship with new Chairman, Robin Southwell.
Spring 2006	David Hurst is seconded from PwC and becomes Scourfield's "right hand man". Hurst is an Insolvency Practitioner from PwC's Corporate Recovery team. Hurst is heavily involved in CJS from June 2006, at which time CJS becomes public within HBoS via data cleansing as part of Basel II preparations. [Paul Burnett receives a Deckard Error report on 29 June 2006.]  There is then a clear agenda to try to "hide" the largest Reading Incident cases with the most potential exposure to money laundering.
3 July 2006	Paul Burnett approves the Pre-Pack in relation to Speyside Angling Services Ltd (Mills company). The debt is clearly incapable of being serviced. Speyside is removed from all MI.  In August, Burnett approves increased facilities for Speyside. The Credit Application shows the strategy, which is to "park" historic unserviceable debt of Speyside and Seoul Nassau, and transfer shares to a topco. Parked debt appears to be standalone, it is likely to be in excess of £35m.
Jul - Dec 06	CJS enters a period of intensive asset realisation e.g. Euromanx House is sold via a sale and lease back. HBoS provide a rental guarantee of £460k, a number of planes are sold with proceeds received in US\$. A US\$ manager's obligation account is set up and 2 other blocked deposit accounts.
July 2006	Sandy MacPherson, MD of Parkmead group is appointed a director of CJS. Parkmead acquired Quayside. Parkmead's bankers are Lloyds TSB. Mills was a director of Parkmead. PwC are appointed as Parkmead's Auditors in July 2006. By this time Southwell has sold his shares in CJS to The Sandstone Organisation, one of Mills' companies, and via which the Lloyds TSB loans are provided (guaranteed by HBoS, ultimate exposure £22m). The group includes a number of Isle of Man registered companies, including EuroManx Ltd in respect of which HBoS has also provided a guarantee of £2.5m to Isle of Man Bank relating to banking facilities they provide to Euromanx. HBoS has provided a significant number of other guarantees on behalf of the group. David Hurst (a PwC secondee) has knowledge of the guarantees and complex structures - he becomes the direct point of contact for CJS, and is involved in asset realisations, guarantees and application of funds.
22 August 2006	Tom Angus holds his first Lead Directors Meeting for Mid Value. First point on the agenda is the Corporate Credit Risk Committee Report.
August 2006	Paul Burnett carries out a portfolio review of Scourfield's own connections.

- 21 Sept 2006 Paul Burnett attends B L presentation by Simon Wheatley (CEO & Quayside). A major restructuring is agreed in principle, which is intended to return the connection to the Good Book [B-L via prior restructuring is owned by Mills' The Sandstone Organisation] HBOs has guaranteed loans from Lloyds TSB (via Sandstone) and from Svenska Handelsbanken (July 2004) [known by David Hurst] It would appear that Paul Burnett approved an increased overdraft facility of £30m, which he did not have the delegated authority to sanction.
- End Sept 2006 FSA review of Nexus by which time data cleansing to be complete. Tom Angus is in receipt of error reports to monitor progress. CJS was an error on 1 Sept 2006.
- October 2006 Tom Angus is concerned about Scourfield's team's portfolio and requests historic credit applications for a number of Scourfield's own connections. After a period of delay of a number of weeks, Scourfield submits them on 1 November 2006.
- 31 Oct 2006 Executive Committee Minutes of 31 October, appear to indicate that Peter Hickman may have made reference to the Reading Incident.
- 30 Nov 2006 Evidence shows that Walker Morris is aware of the Clode Loans.  
Dornier Prop aircraft sold for \$4.15m of which \$2.2m repays CIT (HBoS guarantee released). Net proceeds were to be paid into blocked deposit account but are diverted to repay a Clode Loan. However lawyers later confirm that funds paid to Clode amount to \$1.7m. No explanation is provided for balance of \$250k.
- Dec 2006 A new Lloyds TSB / Sandstone / Euromanx loan for £6.6m is provided. HBOs provide a guarantee to Lloyds TSB. The loan is for the committed purchase by Euromanx GmbH of 2 aircraft, which have been on lease since May 2005.
- 3 Jan 2007 The Lloyds TSB loan had been converted into USD for the purposes of the transaction. \$1.3m of "surplus" loan funds are placed in a Manager's Obligation Account.
- 12 Jan 2007 Tom again expresses concerns about London & South connections and sends Scourfield detailed trend information in advance of a meeting on 15 January.  
Despite having received copies of the historic credit applications from Scourfield on 1 November 2006, Tom Angus asks Paul Burnett whether he has seen and / or approved the Credit Applications. Paul Burnett denies knowledge of them in his response to Tom in February 2007.
- 22 Jan 2007 Peer Review of Reading commences. The Peer Review team are aware of the HBOs / Lloyds TSB bank guarantees.
- 2 Feb 2007 PwC (Rob Birchall) is engaged to carry out Independent Business Review and consideration of the Bank's options for Seoul Nassau followed later by Bradman-Lake.
- February 2007 FSA is given assurance that in relation to Days Past Due Reporting, by 31 March 2007 the Corporate Good Book portfolio will not contain any connections where the limit has expired or covenants have been breached in excess of 90 days. DPD Reporting was to be a principal credit tool and was integral to Advance Bank Status.
- 9 March 2007 Scourfield goes on Sick Leave and is later suspended on 22 March 2007.

- March 2007** Nick Davies, a director of Clode provides the Clode "corporate loan" spreadsheet to Tom Angus' team. All loans are connected to David Mills and "Reading" connections. The loans total £11m, and include loans to Sandstone, Justus (David Mills' personal Isle of Man company), indirectly Seoul Nassau and B-L. The team is fully aware that this is strong evidence of potential money laundering or financial crime.
- A GCM and GIA special project team run under David Miller (Head of Credit Sanction) and Group Credit Risk (Steven Clark) commence their review of the Reading Incident.
- (David Miller issues first report on the Reading Incident in May 2007.)
- Quayside fees totalling £250k are settled. All invoices except one minor one for a company in Administration are paid in full.
- PwC (David Chubb) are engaged to carry out Independent Business Review and consideration of the Bank's options for CJS.
- Reading Incident is reported to the FSA as an internal credit control weakness, which allowed "a member of staff extended unauthorised credit to impaired clients within commercial [mid value corporate] lending". No potential money laundering offences and/or fraud is reported.
- Corporate Financial Crime Prevention are not instructed to carry out a proper investigation. The scope of their investigation is severely restricted and relates only to Lynden Scourfield personally and to KYC checks.
- 12 April 2007** David Chubb is made aware of certain Clode loans. He confirms that Justus Ltd (Mill's personal Isle of Man company) owns the luxury yacht Powdermonkey and that a CJS company, Bluesky has lent Justus €104k. Bluesky was originally owned by Mills and Southwell, who transferred their shares to CJS. Chubb is aware that Bluesky owns another luxury yacht and he confirms that Clode originally gave a loan to Bluesky, which is now in the name of Clive Dixon. Bluesky also have a marine mortgage with Barclays for €973k. Chubb also knows about the Euromanx House guarantee to Slipway.
- 20 April 2007** PwC's IBR report is received. It does not mention money laundering or suspicious transactions. The existing CJS management team have been difficult, evasive and less than forthcoming with essential information.
- 25 April 2007** HBoS AGM Trading Statement.
- 1 May 2007** PwC are instructed to pursue an accelerated Mergers & Acquisition process (sale of the businesses).
- Turnaround consultant, Richard Bingham is approached to consider a cashflow monitoring and reporting role. Richard's proposed engagement is met with considerable resistance by existing management. Richard is a "seasoned-pro" and will undertake his own diligence at a granular level. The "intrusion" is not welcomed by CJS' management.
- 14 May 2007** HBoS Reading Incident becomes public knowledge following extensive media coverage.
- 31 May 2007** Richard Bingham's engagement is reluctantly agreed by CJS management for an initial period of 1 month. The scope of the engagement has been reduced by management from that originally intended by the Bank and PwC.

- 
- 12 June 2007 KPMG commence a credit review audit of Reading connections.
- 30 June 2007 CJS management have not co-operated with Richard Bingham and are being difficult about renewing his contract after the 1 month expiry. They have also not assisted PwC in the AMA process.
- July 2007 An offer is received from CJS' existing management team to acquire the shares in the 4 main operating subsidiaries. Although the offer is extremely low, in the absence of any other better alternative, the Bank decides to pursue the MBO option.
- In view of the potential MBO and no other offer likely, Richard Bingham's contract is not renewed.
- 1 August 2007 HBOS Half Year Results interim Statement.
- PwC and lawyers are involved in structuring CJS to enable the sale of the 4 main subsidiaries to existing management to complete via a day 1 insolvency process.
- 26 Sept 2007 PwC (David Chubb) appointed as Administrative Receivers of CJS. Principal subsidiaries are sold to CJS management's acquisition vehicle, Quest Aviation Services Ltd (Southwell and Shakesby are directors and shareholders; Mills is probably involved via Burwell Nominees). A considerable loss is crystallised.
- 19 Aug 2010 PwC (David Chubb) is appointed Administrators of Mint Partners. David Mills is Chairman. The founding directors have Clode Loans. There are potentially serious financial irregularities. A SOCA investigation is in course.
-



## REPORTING OBLIGATIONS: INSOLVENCY PRACTITIONERS

### Anti-Money Laundering Legislation

Under The Proceeds of Crime Act 2002 and Money Laundering Regulations, duly appointed Insolvency Practitioners and businesses providing accountancy and audit services are obligated to report to the Serious Organised Crime Agency when they have suspicion or reasonable grounds to know or suspect that a criminal offence, which gives rise to criminal proceeds, has been committed. This applies to any criminal activities involving the proceeds of crime.

Guidance on compliance with the anti-money laundering legislation for Insolvency Practitioners and for Accountants was published by the Consultative Committee of Accountancy Bodies in 2004 and 2003 respectively, with subsequent updates.

In relation to Accountancy Firms, the obligation to report applies regardless of whether the actual or suspected offence has been committed by a client or by another party. The report must be made as soon as practicable. The making of a report based on knowledge, suspicion or reasonable grounds for such takes precedence over client confidentiality considerations. Failure to comply with the requirements of either the Regulations or the Act can carry criminal sanctions.

Guidance provides that professional scepticism and judgement should be exercised when considering suspicious transactions and potential money laundering.

Insolvency Practitioners need to bear in mind that, where they suspect the assets of a company to which they have been appointed may be tainted by criminality, selling those assets without consent from SOCA may constitute an offence. Similarly if a Practitioner is suspicious that the funds offered to purchase a business or assets are of criminal origin, again he should obtain consent. Clearly there is scope for conflict between the duty to achieve the best results for creditors and the anti-money laundering legislation. However guidance suggests that the legislation will prevail.

Insolvency practitioners are subject to a number of specific reporting duties, including the requirement to submit reports on directors under the disqualification legislation. Under these various duties the matters to be reported and the nature and extent of the supporting evidence may differ from that required under the anti-money laundering legislation and regulations.

### Section 218 of the Insolvency Act 1986: Dual Reporting to SOCA and The Insolvency Service

It is not the duty of a Liquidator or Insolvency Practitioner to investigate criminal conduct. However under section 218 of the Insolvency Act 1986, Liquidators have a duty to report any past or present officer [director] of a company, or any member [shareholder] of a company, if the Liquidator suspects that person is apparently guilty of an offence in relation to the company for which that person may be criminally liable. A Liquidator, who is an Insolvency Practitioner, is required to report the matter forthwith to the Intelligence and Enforcement Directorate of the Insolvency Service.

Although the statutory duty under section 218 of the Insolvency Act 1986 is specific to Insolvency Practitioners acting as liquidators, best practice dictates that Administrators and Receivers are also encouraged to comply plus all Insolvency Practitioners have a public interest duty both as responsible Insolvency Practitioners and as professionals to report criminal offences.

#### Disqualification of Directors: Insolvency Practitioners Reports on the Conduct of Directors

Under the Insolvency Act 1986, the Companies (Directors Disqualification Act 1986 and The Insolvent Companies (Reports on the Conduct of Directors) Rules 1996, liquidators, Administrators and Receivers are required to submit reports on the conduct of current and former directors (including shadow directors) to the Secretary of State for Business, Innovation and Skills via The Insolvency Service. Reports must be submitted within 6 months of the date of appointment unless the conduct of a director is deemed to be unfit, in which event the report must be submitted forthwith.

Examples of unfit conduct include:

- Breach of fiduciary or other duties.
- Misapplication of assets.
- Trading whilst insolvent.
- Responsibility for the causes of insolvency.

The Insolvency Service will consider whether it is in the public interest for the Secretary of State to investigate and take action against directors. Action against directors is not limited to disqualification but may extend to criminal offences.

Investigations carried out during the ordinary course of an Insolvency Practitioner's work may uncover possible rights of action against directors, which the company, Administrator or Liquidator may have against third parties. Such rights include actions against directors for:

- Transactions defrauding creditors.
- Transactions at an undervalue.
- Extortionate credit transactions.
- Preferences (preferring one creditor ahead of another).
- Mistake and misapplication of property (Liquidation only).

As well as the right of action, such matters are also required to be included when reporting on the conduct of directors. Criminal offences under the Insolvency Act and Companies Act are reported to the Insolvency Services Prosecution Unit.

The Enterprise Act 2002 made substantial amendments to the Administration process including extending certain of the rights of action to Administrators. Previously the rights of action vested in the company / Liquidator.

The rights of action carry certain time stipulations from the date of insolvency, which in most cases is 2 years prior to the date of insolvency. Whilst the date of formal insolvency for Administrations and

Liquidations is the date of appointment of the relevant Insolvency Practitioner, in relation to Receiverships, a Liquidator must be appointed to formalise the date of insolvency. Receivers must be mindful to this and if there is evidence of a right of action then should take steps to immediately appoint a Liquidator, to "start the clock ticking". Any delay reduces the time period caught by the right of action. In simple terms if a Liquidator is appointed more than 2 years after a Receiver has been appointed then the right of action has expired or if the misfeasance happened 1 year and 1 month prior to the appointment of a Receiver and the appointment of a Liquidator is delayed by 1 year then the right of action will similarly have expired.

### **Public Interest Duty**

Insolvency Practitioners are morally bound under their public interest duty to report and / or take action against delinquent directors where there is a reasonable prospect of success. Where there are no assets to cover the cost of action, then that moral obligation is usually underwritten by the chargeholder or bank, as being in the public interest.

# SECTION TEN: THE TURNER CONNECTION

**DRAFT**

## SECTION TEN: THE TURNER CONNECTION

### PAUL & NIKKI TURNER / ZENITH COMPANIES

This section provides an understanding to the background of the Thames Valley Police investigation into the Reading Incident. The Turners concerns and tenacity had a pivotal role in establishing Operation Hornet.

The section is necessarily long to provide a comprehensive understanding into the themes and issues that are raised.

**There are some serious matters for LBG to address. The Turners have been and are being unfairly treated.**

#### CONCLUSION

Eviction of the Turners by LBG has been stayed through the intervention of the FSA in the Court process, pending the outcome of Operation Hornet.

It is difficult to understand the price that the Turners have been made to pay.

Their business was a start up, which was knowingly undercapitalised at the outset and got into the usual difficulties of start ups. They relied on Lynden Scourfield and Quayside.

All the evidence shows that they were crying out for an appropriate business manager. They acted in good faith and on the insistence of Lynden Scourfield provided £200k joint and several guarantees, which they collateralised against their dwelling house.

**There is no one competent who can say whether or not that business would have been successful if they had been provided with appropriate consultants and proper assistance in securing third party investment.**

**They were financially naive and looked to Lynden Scourfield. Lynden Scourfield and David Mills abused that naivety to a gross extent.**

An initial meeting with the Peer Review team in March 2007 was badly handled. The director involved materially influenced decision making thereafter.

It is disappointing that Reading High Risk team members (David Hurst and Steve Gullon) were allowed to provide background information, which was not verified, subsequently augmented and



then relied upon by senior executives in their decision making. Having said that senior executives would appear to have had an entirely different agenda given the timeline of events in August 2007.

If the Turners had been treated properly in 2007 and subsequently in the first part of 2009, then who is to say whether or not they would have felt so compelled to bring their plight and the plight of others to the notice of those that they considered ought to know and who they thought might seek justice for them.

The toll on the Turners has been considerable. Mr Turner is in his sixties, he previously was of good health. He now has a serious stress related illness and is gravely ill. When he is able to eat he is on a strictly liquid diet.

## **Paul & Nikki Turner / Zenith: History**

### **Background**

Operation Hornet has its foundations with the Turners, who are victims of the Reading Incident and who from April 2007 repeatedly tried to bring their concerns and experiences to the attention of senior executives and then the Board.

The Turners are unusual in that they were successful in dispensing of the services of David Mills and Quayside, in early 2006. However the damage to the Turners at the hands of Quayside was largely done by that time and it prove impossible for the Turners to service the magnitude of debt that had amassed under Quayside's stewardship (it had increased by c.£800k, including fees).

The Zenith companies were in the music industry and were specifically record producers and music publishers.

The Zenith companies were effectively a new start-up in February 2003. The businesses were insufficiently capitalised at the outset. However, HBoS knew this. The business plan that formed the basis of the deal Credit Application showed a capital requirement that was 3 times that that was provided by way of SFLGS term loans.

Corporate provided facilities totalling c.£250k, the majority of which were SFLGS term loans. The Turners attempted to secure an investor in the business but that prove extremely difficult, not helped by their inexperience in such matters. The connections were referred to High Risk in August 2003. Lynden Scourfield took over the relationship role. In April 2004 he introduced Quayside as a condition of continuing support. Thereafter facilities escalated.

The Turners had operated their businesses from home. HBoS had historically provided a mortgage via Birmingham & Mid-Shires (c. £420k). Corporate lending in 2012 was c. £1.5m. The Turners also have a heritage overdraft of £20k with Lloyds TSB, secured by a second charge over the dwelling house. In May 2004 on the insistence of Lynden Scourfield, the Turners provided joint and several personal guarantees for £100k in support of increased Corporate facilities, secured by a third charge over the dwelling house, the PGs were increased to £200k in October 2005, again on the insistence of Lynden Scourfield.

The Turners were unable to service their mortgage and it went into arrears in 2006. Birmingham & Mid-Shires commenced possession proceedings in November 2006. Despite it being part of Quayside's role, they had not prepared any Management Accounts for the companies and the Turners by then could not afford the services of an Accountant. Quayside had further not introduced any potential investors, and despite positive commentary on the business from an industry specialist.

Quayside had invoiced the Bank directly for their "services" and Lynden Scourfield had processed payment without the authority of the Turners. That arrangement had continued after the Turners had dispensed with Quayside's services in February 2006 (Lynden Scourfield was aware).

Despite the lack of Management Accounts, there is considerable evidence to show that the Turners kept the Bank fully apprised of all developments in the business, invoices raised and debts outstanding. It is very clear that the Turners had needed a proper business manager / consultant. It is also very clear in the absence of one, the relationship they had with the Bank was a special relationship. They were obviously financially naïve.

#### **HBoS High Risk and Impaired Assets: March 2007 to December 2008**

On 26 March 2007 Andrew Scott was provided with evidence by a director in another Reading case to show fraudulent conduct, strongly suspicious of money laundering, amounting to £11m. The director alleged that Mills and Scourfield were responsible.

On 28 March 2007 the Turners had a scheduled meeting with Lynden Scourfield, which had not been cancelled on his suspension on 22 March 2007. Andrew Scott held the meeting and it is clear that it was difficult and not best handled. He was probably aware of that and the wraparound that was subsequently approved by Hugh McMillan, if it follows the misleading tack of subsequent notes, Emails and other file evidence, probably didn't properly represent the facts of the case. Hugh McMillan's response was or was effectively:

*"Give it 4 weeks then call it up."*

On 18 April 2007 David Hurst, who had become involved in the connection in the final quarter of 2006, appeared overly keen to persuade Tom Angus to make formal demand. There is no denying that the management of the banking relationship was time consuming, but that was the making of Lynden Scourfield.

At the time of David Hunt's enquiries with Tom Angus, the Turners were already in course of writing to Peter Cummings and did so on 10 April 2007. David Hunt and Steve Hadwin prepared a briefing paper for Peter Cummings which Tom Angus copied to Hugh McMillan. The briefing paper accurately stated the facts and accurately portrays the Turners in a poor light.

On 13 May 2007 Hugh McMillan met with the Turners and agreed a temporary temporary residential facility of £10k for 3 months and also agreed to refund Chryside bank that had been paid post February 2006. Part of the conditions of support was the production of audited accounts for the 2 years ended 31 December 2006. The Turners made their complaints about Southfield and Chryside clear to Hugh McMillan and Fraser Kelly, who was also present.

The Bank did not refund the Chryside bank. An issue that was highlighted from the Turners' phone audit was delayed, additionally and it is noted in the audit industry notes were delayed, and in the absence of the refunded bank, the Turners had no supplier money to pay for accounts to be prepared. The Bank had not been in contact and in the absence of an assigned RMA, the Turners had talked with David Hunt (a PwC associate and close associate of Southfield).

On 17 July 2007 Fraser Kelly wrote to the Turners asking for a progress report and expressing concern that the temporary residential facility was not to be fully shown. The Turners responded and explained that the bank had not been refunded as agreed. Fraser Kelly responded on 27 July 2007 and in his response he explained that he was moving roles and so they should contact Andrew Scott. The response asked for evidence to justify the refund, a matter which the Turners considered to be already agreed by Hugh McMillan with the information (bank history of directly to the Bank) already available to the Bank.

#### August 2007

In the intervening period the Turners had become aware of a number of irregularities relating to Lyndon Southfield and Chryside, and had undertaken their own enquiries. They had received no further update from the Bank in terms of their own complaints regarding Southfield and Chryside.

On 6 August 2007 they wrote to Peter Cummings and Hugh McMillan. In their Email, there was a thinly veiled threat to go to the media.

On 8 August 2007 the Bank initiated the process to call up the debt. Customer Care sent out a response to the Turners' Email to Peter Cummings and Walker Morris was instructed to draft documentation. On 12 August 2007 Paul Turner was quoted in the Sunday Telegraph business section. On 14 August 2007 the Turners' responded to Customer Care. On 15 August 2007, Peter Cummings contacted Hugh McMillan. On 17 August 2007 a new update was provided to Peter Cummings and the Press Office. Tom Angus had been involved in the drafting. It is misleading and does not present a true picture of the case.

At the time of David Hurst's exchanges with Tom Angus, the Turners were already in course of writing to Peter Cummings, and did so on 19 April 2007. David Hurst and Steve Gullon prepared a briefing paper for Peter Cummings, which Tom Angus copied to Hugh McMillan. The briefing paper misrepresented the facts and incorrectly portrays the Turners in a poor light.

On 15 May 2007 Hugh McMillan met with the Turners and agreed a temporary increased overdraft facility of £40k for 3 months and also agreed to refund Quayside fees that had been paid post February 2006. One of the conditions of support was the production of audited accounts for the 2 years ended 31 December 2006. The Turners made their complaints about Scourfield and Quayside clear to Hugh McMillan and Fraser Kelly, who was also present.

The Bank did not refund the Quayside fees. Income that was anticipated from the Turners' prime artist was delayed, additionally and is as normal in the music industry, contracts were delayed, and in the absence of the refunded fees, the Turners had no surplus monies to pay for Accounts to be prepared. The Bank had not been in contact and in the absence of an assigned RM, the Turners had liaised with David Hurst (a PwC secondee and close associate of Scourfield).

On 17 July 2007 Fraser Kelly wrote to the Turners asking for a progress report and expressing surprise that the temporary overdraft facility was more or less fully drawn. The Turners responded and explained that the fees had not been refunded as agreed. Fraser Kelly responded on 27 July 2007, and in his response he explained that he was moving roles and so they should contact Andrew Scott. The response asked for evidence to justify the refund, a matter which the Turners considered to be already agreed by Hugh McMillan with the information (fees invoiced directly to the Bank) already available to the Bank.

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**What is disturbing is at that time, the Bank was fully aware of the fraud and probable money laundering that had been perpetrated across a number of Reading Incident cases. Evidence on the Reading Incident also shows highly questionable conduct by Scourfield.**

On 22 August 2007 the Bank called up the Corporate debt and personal guarantees.

### **Possession and Eviction**

The Turners' continued to try to find a way forward with the Bank. The Bank prevaricated with what in the circumstances (lack of funds) were unreasonable requests. The Turners continued to lodge complaints with the Bank and began to build up further evidence of Scourfield, Mills and Quayside related irregularities.

Between October and December 2007, there were various exchanges of correspondence, which are discussed below.

The Turners had and have been unable to secure legal aid and have had to represent themselves. They first defended Birmingham & Mid-Shires' action to obtain a warrant for possession of the dwelling house. The defence co-joins Corporate on the basis that it was the Zenith businesses that were the source of funding for the mortgage. An initial Court Hearing in October 2007 resulted in an adjournment of the possession application to April 2008 at which time the Court Order provided for a resolution of the dispute with the Bank, which involved the Turners having to lodge £50k in return for a new facility (no new Bank monies). Information on file shows that the bank considered that this was no a realistic proposition

In July 2008 the Bank increased the Zenith provision from £822k to £940k (Wraparound dated 30 July 2008). A Possession Order in favour of the Bank was granted in November 2008.

By the end of 2008 the Bank did not expect to make any recovery of the Corporate debt, including any recovery under the personal guarantees, and it was fully provided for (Wraparound 6 November 2008):

Referring to the Court Order: "The whole affair is a colossal waste of Bank time....."; and  
Recommending: "Meet with the Turners if, and only if, absolutely necessary....."

Up to that time the Turners' had been escalating their concerns within HBOs to a senior level and had engaged the support of a number of MPs, who had received similar representations from Reading Incident customers involving irregularities connected to Lynden Scourfield, Quayside and David Mills.



## LBG

### Corporate recovery action from January 2009

In November 2008 James Paice, representing himself and a number of other MPs, wrote to Lord Stevenson, the result of which was a meeting with Philip Grant and Andrew Scott on 27 January 2009. The Bank followed up the meeting by letter on 18 February 2009 including an initial offer as discussed below, and James Paice responded on 4 March 2009. The MPs raised issues including:

*"We are concerned that by addressing the individual cases you are not addressing the bigger picture of Lynden Scourfield's involvement."*

*"We have considerable further evidence about other cases."*

The compromise agreement on offer in February 2009 offered the Turners refund of Quayside fees totalling £65K, to be applied against the Corporate debt. In essence this offered them nothing.

The offer was subsequently amended in March 2009 and this is where LBG may have erred. The revised offer was made to James Paice and was not discussed with or explained to the Turners. The Bank then did not subsequently engage with the Turners or James Paice to ensure they understood the revised compromise agreement. Thames Valley Police have confirmed that the Turners have only ever referred to the refund of the Quayside fees as being offered by the Bank.

The letter that was sent to James Paice on 18 March 2009 provided for:

*"BoS was prepared to credit the sum of £65k to Mr and Mrs Turner's mortgage account."*

*"BoS was minded to write off the sums which are outstanding from the Zenith Companies."*

James Paice had been seeking an amendment to the earlier offer such that the Quayside refund of fees was applied against the mortgage arrears. That was the expectation that the Turners were being managed towards by James Paice. James Paice copied extracts of the letter he received to the Turners. The second part of the offer may have "got lost in the translation" as it wasn't particularly clear if this was or wasn't part of the offer, and what the conditions were that attached to the rather unclear comment. It also didn't clarify the position regarding the personal guarantees. It might well be that the Turners didn't and haven't recognised the comment as being part of the offer. Unfortunately LBG did not engage with them or James Paice to provide clarification.

The following are extracts from an Email from Andrew Scott to Philip Grant on **16 March 2009**, which was drafted using advice from Rory McAlpine. It was written in course of drafting the revised offer letter to James Paice MP. At that time the offer that Philip Grant had suggested was to **refund Quayside fees of £65K, write off the Corporate debt and release the Turners from their guarantee obligation** in exchange for a compromise agreement. Andrew Scott and Rory McAlpine were concerned about the strategy.

"The Turners will, in all likelihood boast via the National Press..." "Turner will interpret our goodwill gesture... as confirmation of the bank's culpability and there is an on balance probability that he would then try to sue the Bank, its employees or its advisers for damages..." "It will encourage Turner to revert to Freer\* and indeed any future parties to act as a consultant..." "he will plead his case with the Judge all at the expense of the Bank"

\*(Mrs Freer's business had significant potential for success until the intervention of Quayside (Michael Bancroft). She signed a compromise agreement which released her from a personal guarantee of £600k, which she later contested as having been signed under duress. She won the case and the agreement was set aside. As threatened by Philip Grant in his letter of 18 March 2009, LBG then enforced the guarantee. She lost her home. She had 5 young children.)

James Paice responded to Philip Grant's letter of 18 March on 2 April 2009 and expressed concern at the Bank's stance. On 30 April 2009 Philip Grant responded and advised that if the offer was not accepted then the Bank would take forward the Possession Order.

On 13 May 2009, Rory McAlpine provided a note in which strategy was reassessed in light of developments and potential publicity attaching to the upcoming BBC Radio 4 File on Four programme on 26 May 2009, which was an exposé. In particular Rory McAlpine was strongly in favour of enforcing the Possession Order over the house that had been obtained on 18 November 2008:

1. *Having made the threat to enforce it would be prudent to implement that threat;*
2. *The offer to the Turners was significantly more generous than any solution which the Financial Ombudsman has power to impose;*
3. *There is reason to suppose that the parliamentary campaign may have fizzled out [McAlpine then explains that the other Reading Incident customers represented by the MPs had been or were being dealt with via the offers made to them or otherwise].*
4. *If BoS does not make clear that the offer is withdrawn there is a greater risk that the Financial Ombudsman may seek to persuade BoS to provide more generous compensation.*
5. *There is a possibility that once Mr Turner recognises the inevitability of his eviction, he will resign himself to his fate.*
6. *If BoS were to reactivate the enforcement there is likely to be a delay of at least a fortnight before any eviction takes place. There would be virtue in postponing any action until 22 May, which would ensure that the Turners did not receive any communication about eviction until after the BBC programme had been finalised and indeed broadcast.*

James Paice responded to Philip Grant's letter of 30 April 2009 on 22 May 2009:

*"your response is inadequate" "you are trying to buy off the "noisy" cases and ignore the wider issues" "at our meeting we were all of the view that the behaviour of Lynden Scourfield was highly questionable" "Your subsequent response was quite dismissive of that matter" "There are much bigger issues here" "which should be properly addressed by the regulatory authorities" "concluded that the whole matter needs to be raised in Parliament and formal request made for official investigation" "I will outline the situation and the perceived lack of willingness by the bank to address the fundamental points."*

The radio programme File on 4 aired on 26 May 2009. The Hasard debate in the House of Commons was on 2 June 2009 and resulted in referral of the matter to the FSA

On 8 June 2009 Philip Grant wrote to the Turners on Lloyds TSB letterhead and advised them that the Bank was taking steps to enforce its Possession Order. On 11 June 2009 LBG proceeded to enforce the Possession Order.

The Turners defended the eviction notice. Two further Court Hearings were adjourned, the last of these in December 2009 at the intervention of Hector Sants (FSA). At a further hearing in January 2010 all of the Bank's legal actions were set aside pending the outcome of the FSA investigation and any further criminal investigations relating to the Reading Incident i.e. Operation Hornet. This was again at the intervention of Hector Sants.

The Impairment Proposal Templates dated 21 February 2012 for Zenith Publishing Ltd and Zenith Café Ltd prepared by Steve Gullon confirm the following:

*"In the light of the ongoing "Project Windsor" issues which have realistically evolved from this case..." "In view of the potential public prominence of "Project Windsor" issues, it is considered probable that all Zenith exposure will be written off by the Bank upon conclusion of the FSA, Financial Ombudsman and Police investigations." "No further action is considered appropriate against Mr & Mrs Turner."*

## The Turner Files

By August 2007 the Turners had themselves compiled a large amount of substantive evidence to indicate strong suspicion of serious irregularities relating to the Reading Incident. After the Zenith debt and their personal guarantees (put in place at the insistence of Scourfield and Quayside) were called up on 22 August 2007, the Turners wrote to each member of the HBOS Board.

On 4 October 2007 the Turners again wrote to Lord Stevenson regarding their complaint and the other irregularities they had identified. Tom Angus responded. There was a further exchange of Emails in November 2007.

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Having received no satisfactory responses, the Turners escalated their concerns to the Bank of England in September 2007 and then in November 2007 to the Prime Minister, the Chancellor of the Exchequer, the Chairman of the Treasury Select Committee, the FSA and to various MPs.

#### **2008 Rights Issue**

In view of the Bank's unwillingness to provide a senior platform to at least hear the Turners' concerns in relation to the Reading Incident, including the Turners' own treatment, the potential loss of their home and the culpability of Quayside and Scourfield for that loss, and the evidence of other financial irregularities that they had become aware of, in December 2007 they sought a counsel with their local MP, who was James Paice. James Paice wrote to Lord Stevenson on 11 December 2007. By 19 March 2008, Mr Paice had not received a response.

In March 2008 the Turners provided further documentation in relation to the Reading Incident to Mr Paice and in May 2008 Mr Paice wrote to Hugh McMillan, who had left HBoS by then. Andrew Scott responded and there was a short exchange.

On 23 May 2008 the Turners once again tried to engage with Peter Cummings. This time through the network of MPs a number of Reading victims had been identified and the Turners, having compiled potential evidence took it on board to represent the group. Denton Wilde Sapte responded on behalf of Peter Cummings. It would appear that for obvious reasons relating to disclosure matters the reply was somewhat dismissive and inappropriate.

#### **Through to the Lloyds TSB Takeover**

On 6 October 2008 the Turners wrote to the Prime Minister. Whether the Turners knew it or not but in one paragraph they identified what was known to all those involved in the deception:

*HBoS had been insolvent for some time and that Going Concern issues unconnected to the financial crisis had been known about prior to the financial crisis.*

On 18 June 2009 the Turners wrote to Eric Daniels. The letter contained sufficient substance to give cause for concern.

The Parliamentary debate brought forward potential new evidence and victims. The Turners wrote to Hector Sants on 3 July 2009. On 27 July 2009 the Head of Enforcement contacted the Turners and requested any further new evidence. On 4 August 2009 Greg Southall interviewed the Turners at length at their home.

On 19 October 2009 a summary report was submitted to the FSA by the Turners on behalf of a number of contributors. The report was subsequently sent to the Bank of England, the Treasury Select Committee, the EU Commissioners, the Prime Minister and other senior cabinet members. There were then various subsequent exchanges of Email. (The date of the Deloitte engagement letter is 23 October 2009.)



**2010**

In relation to the continuing Court actions to seek enforcement and eviction of the Turners from their home, Hector Sants provided a letter to the Court in January 2010, which resulted in a stay on actions pending the outcome of the FSA investigation and any subsequent criminal investigation.

In June 2010 Operation Hornet was formally launched.

DRAFT

## SECTION ELEVEN: SUSPICIOUS MARKET CONDUCT

DRAFT

# MORGAN STANLEY: RIGHTS ISSUE JOINT UNDERWRITERS AND JOINT SPONSOR

Market Conduct Suspicion: 24 July 2008

## Background

Morgan Stanley made a significant profit when it shorted 2.35% of HBOS immediately prior to the closing on 18 July 2008. It was widely expected that the subscription rate for the Rights Issue would be poor but not to the extent it was (8.3%). As long as a Chinese Wall was maintained between the trading desk and the HBOS relationship side of Morgan Stanley, which would know how badly the take-up had been, then there was no wrongdoing. The FSA cleared Morgan Stanley as they had been responding to orders from hedge funds, who were covering their own short positions.

(Better than expected news overnight from Citigroup had boosted the whole banking sector, so the HBOS share price briefly broke back through the rights issue price of 275p. Morgan Stanley (trading desk) shorted the shares on the premise that the positions would be covered by the underwriters' stick. It was a significant bet (£250m) but it was not implausible that the stick would be significant. The demand for the shares may have evaporated over the weekend if there was bad news on the financial sector, which was a strong possibility, leaving Morgan Stanley with a very significant stick. Noting that HBOS shares had been trading at below the Rights Issue price in the days before the closing, Morgan Stanley did not short HBOS shares at any time during the rights issue process, despite being allowed to do so, although it shorted other banks as proxies to hedge its exposure.)

Following the earlier placing of shares (£1.2bn, 29.5%) by Morgan Stanley and Dresdner (who didn't declare any short positions), meant that Morgan Stanley at the closing were still holding c. £750m, which was just below the 3% disclosable holding.

At that point in time, a number of hedge funds and City institutions were still sitting on very significant loss positions.

Prior to 24 July 2008 and the rumour, HBOS shares were trading at below the Rights Issue price of 275p, at 260p.

## 24 July 2008

On 24 July 2008 false rumours of a takeover bid for HBOS by Spanish Bank BBVA forced the HBOS share price to 305p (17%), allowing Morgan Stanley and Dresdner to sell more of the rump 'overhang' and make substantial profit. At that time it was estimated that they had reduced their

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combined position to less than 5%. The false rumour also allowed other hedge funds to close out positions, possibly generating large profits in doing so.

There is nothing wrong with the dealing as long as the market had not been manipulated. The source of the rumour may have been investigated by the FSA but has otherwise not been revealed.

BBVA was considerably smaller than HBOS, which combined with the declining property markets, financial crisis and rumours in the market place concerning the solvency of HBOS, and noting that the Interims were imminent, made the BBVA rumour unlikely but not implausible.

It should also be noted that HBOS' ordinary shareholders were meanwhile deprived of any proceeds that might have been made from the sale of the rights on their behalf.

## EVENTS IN MARCH 2008

### Coincidental Events Leading up to the Suspension of Shares on 19 March 2008

On 17 March 2008, Sir Callum McCarthy (Chairman of the FSA) telephoned Lord Stevenson.

On 18 March 2008, Lord Stevenson responded. Within his letter he expresses his concerns about malicious unfounded rumours from those with criminal intent to manipulate markets and create a "hit or run on an institution".

The comment doesn't refer to the telephone conversation they had had on 17 March 2008, and is strangely out of context.

Before the markets opened on 19 March 2008 a rumour circulated about HBOS having liquidity problems. The share price dropped by 17% before the FSA suspended shares and then made the unprecedented move of making a statement to quash the rumour.

A rather spurious story was spun, when on the previous Friday (11 March) Corporate colleagues were told that no new business was to be written whatsoever. It appeared obvious that capital and liquidity were an issue. The news was generally out there; it was not a secret.



## SECTION TWELVE: POTENTIAL CLAIMS

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### POTENTIAL CLAIMS

#### HBoS Shareholders

HBoS Shareholders may have potential claims in relation to the 2006 and 2007 Annual Report and Accounts, the Rights Issue which completed in July 2008, other information announced on the Stock Exchange from potentially January 2007 and, albeit remote, the November 2008 Open Offer and Placing

Shareholders may have claims against KPMG.

#### Lloyds TSB Shareholders

Lloyds TSB Shareholders may have potential claims the liabilities for which are complicated.

It is highly probable that the acquisition of HBoS would not have proceeded if the Reading Incident had been disclosed.

Lloyds TSB shareholders may have potential claims in relation to misleading statements and omissions in the HBoS 2007 Annual Report and Accounts, the Rights Issue Prospectus and the 3 November 2008 and 12 December 2008 Trading Updates, as included in the Lloyds TSB Circular, Prospectus and Supplementary Prospectus.

Additional investigation is required regarding the inquiries made by Lloyds TSB in October 2008 following receipt of evidence from a Lloyds TSB customer of potential financial irregularities relating to the Reading Incident, which should have given rise to cause for concern. Lloyds TSB acknowledged receipt.

Additional investigation is required regarding due diligence carried out by PwC in November and December 2008, and in particular with regard to whether or not PwC were provided with the full Corporate Credit Committee reports.

|| The loss to Lloyds TSB shareholders resulting from the acquisition has been estimated at £14bn. ||

### Reading Incident Customers

When considering potential claims of customers against the Bank, it must be first established whether or not additional facilities advanced and / or the engagement of QCS gave those customers a reasonable chance of surviving. There are so many intangibles that it is doubtful whether there is any competent authority who could opine on this aspect.

Similarly for those businesses where customers effectively lost control it is unlikely that it can be established whether loss of businesses and hence income, or additional personal monies injected after the introduction of Quayside, or personal guarantees ultimately called up and settled, is loss either wholly or in part, attributable to the actions of Lynden Scourfield and/or Quayside, which otherwise would not have crystallised if the businesses had been left under the stewardship of these customers.

A factor which will also be taken into account in assessing compensation claims is how diligent the Bank has been in uncovering the fraud and money laundering.

The situation is also "muddied" with regard to time limits for bringing actions, and also with regard to the criminality aspects.

## READING INCIDENT LEGAL COMPLEXITIES

### Good Faith

The potential claims of the victims of the Reading Incident are legally complex. This is compounded by a lack of formal documentation e.g. facility letters and Bank correspondence, QCS engagement letters and / or agreed terms of engagement, the nature of the relationships between QCS, Lynden Scourfield and HBoS, and not the least the fraud and money laundering aspects.

Key considerations must be the relational aspects and Scourfield and others' abuse of trust.

HBoS also made false representations in relation to David Mills and QCS, and as such the victims should be entitled to damages for misrepresentation on the basis that HBoS had induced (in fact unfairly influenced through threats) the victims to unwillingly consent, without separate legal counsel, to the engagement of QCS and the subsequent course of events.

The observance of reasonable standards by HBoS in relation to business conduct that was not improper, commercially unacceptable or unconscionable, should at the time been key aspects of good faith. Clearly such standards were not observed.

The relational aspects here go far beyond what is a normal and reasonable banking relationship, even when the customers involved were within the High Risk arena. These were not impaired customers but customers, which the Bank was supposed to be heavily involved in "turning around". Noting of course the prevailing direction from the Board of avoidance of impairment and non crystallisation of loss, which within Reading and for David Mills and associates, meant criminal opportunity.

Undue influence and duress in the context of the Reading Incident are commented upon in more detail below. Both are an abuse of unequal bargaining power.

Threats to withdraw funding and /or instigate Insolvency proceedings affect customers' decision making. There are of course other factors relevant to the Reading Incident cases. There is evidence to strongly suggest that there was coercion of will so as to vitiate consent.

#### **Undue Influence**

No court has attempted to define fraud and no court has attempted to define undue influence. Both are assessed on the facts of the individual cases.

Ordinarily the presumption of undue influence would not apply between a bank and customer, for the reasons explained below. However the circumstances of the Reading Incident are so unusual, beyond normal reason and "manifestly disadvantageous" to the victims, that undue influence must be considered.

Given the elapse of time then ordinarily the statue of limitations would apply. However HBOs was on notice of misfeasance, fundamentally inequitable treatment of customers, suspected money laundering and the gross misconduct and involvement of HBOs employees as far back as January 2007, if not much earlier.

To prove undue influence there must be evidence to show:

1. Capacity to influence;
2. Influence was exercised;
3. Exercise was undue; and
4. Exercise brought about the transaction.

What is clear is that Lynden Scourfield, with the apparent authority of the Bank (which Philip Grant has committed to writing), established a special relationship with the Reading victims. A special relationship gives rise to a presumption of influence only but not undue influence. If the relevant "transaction" in question is suspicious (which again is extremely relevant to the Reading Incident) then a second evidential presumption, of undue influence will arise.

Even in the unlikely event that it is considered that no special relationship exists then the relationship can be nevertheless one of "trust and confidence", where one party is in a position to exert undue influence over the other. The victims must show they placed trust and confidence in Scourfield / the Bank

Whether Scourfield and others applied unacceptable pressure will depend on the merits of each case, however it must be proven that the will to resist had be worn down. In relation to certain of the Reading cases, Fleming J could well have been thinking about them when he likened "the difference between legitimate persuasion and excessive pressure, like the difference between seduction and rape".

There is also the highly relevant issue of concealment of material facts by Scourfield and others, the effects of which would be known by Scourfield and the others e.g. QCS' excessive fees, QCS' lack of proven track record (or in actual fact abysmal track record), and QCS' and Scourfield's true motives. Failing to disclose all material facts impairs autonomy of free will because it prevents a fully informed decision, which Scourfield combined with excessive pressure. In this context there is of course the overlap of the separate grounds of undue influence from concealment of material facts and fraudulent misrepresentation.

Undue influence may be rebutted on the basis that the "weaker" party exercised independent free will. However it must additionally be proven that the "weaker" party fully understood the transaction and that the transaction that was entered into was as intended. This latter point has to be severely questionable as it would appear that there may be grounds for fraudulent representation.

In addition the Courts take a strict view with regard to reasonable alternatives, even if those might be unpalatable. This latter point may be highly relevant to Reading Incident cases but each case must be assessed on the basis of its own merits.

### **Duress**

Duress occurs where there is abuse of position by the dominant party and thus of the trust and confidence reposed in that party such that the act of contracting by the weaker party is not a voluntary act. Additionally the dominant party must be acting in bad faith (illegitimate pressure) and the pressure must be significant.

Duress therefore encompasses undue influence, duty of care, fiduciary obligations and good faith.

Where duress involves threats to engage in a legal process e.g. Insolvency action, although in some circumstances this may be lawful, it will always be unlawful if the threat was made in bad faith. There is also the case that what is being threatened is a legal wrong.

Transactional imbalance is compelling evidence that duress has been exercised.



It has to be considered whether the victim had any realistic practical alternative but to submit to the pressure and also whether the victim protested at the time.

The difference between undue influence and economic distress (where the parties are already in a contractual relationship and the abuser takes advantage of the plight of another) is that undue influence involves psychological pressure whereas economic duress is the use of economic pressure. An important distinguishing factor is also that it is the common law doctrine of distress whereas the equitable doctrine of undue influence.

In relation to the Reading Incident, the victims appear to have been deprived of the power of choice through the threats that were made by Scourfield and others in abuse of their positions. However for each case there had to have been an assessment by the customers of the seriousness of the risk of enforcement against the potential benefits of accepting the risk. This is by no means straightforward when personal guarantees are involved.

Taking the reasonable man argument, on balance there is a strong argument that the Reading Incident victims would not have entered into the transactions forced on them by Scourfield and QCS. Those transactions are therefore wrongful in the sense that one party was victimised by another.

#### **Fiduciary Duty of Banks**

Both undue influence and duress have a fiduciary element as well as underpinning the duty of good faith.

Historically case law provided that a bank has no duty of care to any of the other parties involved in the lending contract, and in particular in relation to how the bank reaches the decision on how to recover its debt. This is the general principle that no duty of care exists between a debtor and creditor.

As banking has become more complicated, case law is adapting.

The general principle of law is also that customers are responsible for their own choices and accordingly, there is no general obligation for businesses to protect their customers from making unwise choices.

The function of fiduciary law in basic terms is to act as a deterrent against cheating.

Banks until relatively recently in history were partnerships. It may be an old fashioned view, but those roots made bankers risk averse and focussed on the long term needs of their customers, to whom they had open ended liability. Fiduciary or not, this forced honesty in the system.

A fiduciary duty is a legal relationship between one party, the principal, who is dependent on the better knowledge and judgement of the person he trusts, the fiduciary. A fiduciary duty is the

highest form of duty and contrasts with the ordinary tort duty of care, which seeks only to avoid harm.

There are four situations, which have been identified in which a banker may become a fiduciary in relation to its customer:

1. Receives or transfers funds of its customer;
2. Gives advice where it is in a position of conflict of duty and interest;
3. The banker is in a special relationship with its customer and is in a position of conflict of duty and interest;
4. Where a bank makes a mistaken payment to another.

In relation to the special relationship situation, it must be shown that the customer relies on the bank and the bank is aware of that reliance, and there is a relationship of confidentiality.

The basic remedies for breach of fiduciary duty are far more favourable and include equitable compensation. In addition equitable remedies and claims for equitable remedies are not time barred by the Statute of Limitations in the way that common law damages are.

A common law fiduciary duty is an obligation to act in the best interests of another party giving rise to a complete loyalty to the service of another's interests. This duty has several facets:

- A fiduciary must act in good faith;
- He must not make a profit;
- He must not place himself in a position where his duty and his interest may conflict;
- He may not act for his own benefit or the benefit of a third person.

Significantly for the customer, this relationship imposes a more extensive duty of care than found in tort. Established categories of presumed fiduciary relationships include agent and principal, solicitor and client, and doctor and patient, although the Court can impose a duty in any relationship subject to the facts of a case.

In *Woods v Martins Bank Ltd* the Court accepted that a fiduciary relationship was born where a bank manager acted in an advisory capacity. The reliance upon the advice and expertise of a bank by a customer can create fiduciary obligations, however the imposition of such duties by the Court ultimately depends upon the facts of each case.

There is great difficulty in importing an equitable doctrine into the law of commerce. However common law merely requires honesty, diligence and performance of contractual obligations, but equity requires nobler qualities of loyalty, fidelity, integrity and respect for confidentiality, which are positive requirements reflected in the complexity of modern day banking.

### **Fiduciary Duty considerations applied to the Reading Incident**

Banks will always argue that a bank has no fiduciary responsibilities towards its customers and acts purely in a contractual relationship. As such any suggestion of an implied duty to take reasonable care when dealing with a customer will be rejected.

The Reading Incident is however extremely complicated and the actions of HBoS went considerably further than a normal "High Risk / Impaired Asset" relationship or a banker / customer (debtor / creditor) relationship. In doing so HBoS failed to exercise the level of skill, integrity, honesty and care that it was reasonable to expect of a competent and regulated banking organisation.

It should always be remembered that it has to be strongly contended that HBoS would act fairly as a creditor and in good faith to the ultimate Reading Incident victims. HBoS clearly did not and further exacerbated the loss and distress ultimately suffered by many of the direct and indirect victims.

Some comment needs to be made about David Mills and other QCS "consultants" and the capacity under which they were acting. There are obvious issues relating to their conduct and duties as directors to the Reading Incident companies to which they were appointed. There are also "shadow director" issues, where Mills and associates had executory powers or otherwise acted in a managerial capacity in relation to the Reading Incident cases, but there were no formal directorship appointments. Both of the foregoing should have been considered and adversely reported upon by the Insolvency Practitioners, who were appointed to Reading Incident cases. The Bank's involvement in those appointments, the executory powers imposed and subsequent granting of increased facilities exposes the Bank to significant risk. The relationship between QCS and HBoS is one that requires specific legal opinion, which should encompass consideration of the duty of care, fiduciary duties and other duties QCS owed to the victims of the Reading Incident, given the Bank owed a duty of care to the victims when imposing the "services" of QCS and David Mills onto the Reading Incident victims.

There is also the complication of "asset stripping", excessive fees, leakage of significant additional facilities post involvement of David Mills and QCS.

There are a number of other considerations:

- The criminal conduct of HBoS employees;
- The otherwise complicit involvement of HBoS employees including those in an oversight function;
- The complicity and misconduct of KPMG;
- The delinquency / misconduct of senior executives and the Board of HBoS;
- The actions of HBoS and the Insolvency Practitioners post formal "discovery" in January 2007.

RESTRICTED STATEMENT SALLY MASTERTON  
INTERVIEW 10<sup>th</sup> / 11<sup>th</sup> July 2013

**Liability for Employee Misconduct**  
An employer is vicariously liable in tort for the wrongful acts of its employees committed during the course of their employment, where they are acting on the employer's behalf. Responsibility extends to the costs of the misconduct.

While on the face of it, as was the basis of historic case law, no employer employs an individual to be dishonest or to commit crimes, case law now extends to cover any fraud which is closely related to an employee's employment. The defrauded individual or company must have been assured or led to believe by the employee or have inferred through course of dealing, that the employee had authority.

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# APPENDICES

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APPENDICES



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In essence it can be summarised by the following

**The Bank of Scotland culture became a necessity for HBOS:**

***"A primary focus on controlling absolute levels of loss."*** Executive Committee 17 May 2005

2005 Board Meeting 27 May 2007

***"It could be disastrous if market sentiment moved***

***against HBOS."*** Executive Board October 2007

At a basic level, if the Reading Incident had been properly disclosed in the 2007 Annual Report and Accounts then it is unlikely that the Rights Issue would have been capable of proceeding and irrespective of whether the Government stepped in or not at that time to prevent the collapse of HBOS, it is unlikely that the acquisition by Lloyds TSB would have occurred.

The following synopsis provides a "cradle to grave" account:

### The Fallacy

In 1999 "new Corporate" came into being in Bank of Scotland and marked a sea-change; positioning itself towards highly leveraged, equity and structured deals. It was at this point in time that the die was cast.

## APPENDIX I

### A BRIEF SYNOPSIS OF THE HISTORY THAT GAVE RISE TO THE HORNETS' NEST

This section provides inside knowledge of the culture and dynamics of Bank of Scotland into HBoS and through to the ultimate demise of HBoS. It explains the motivation and importance at Board level for keeping the Reading Incident concealed.

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relatively small in today's terms. The Bank of Scotland favoured a growing number of "entrepreneurs" with alleged (unproven) turnaround success.

Bank of Scotland's culture was resistant to recognition of distress and was strongly averse to impairment and crystallisation of loss. The business was incentivised to restrict impairment.

### **The Merger**

Under HBoS and the high risk business strategy that was pursued, which involved a significant and increasing funding gap, the culture of non recognition of distress and impairment became a necessity. It was an inherent part of the business model. The practice was formalised and known.

The HBoS merger strategy was predicated on market sentiment. The high risk strategy was known to the market so HBoS had to deliver and outperform. To do otherwise would result in downgrades of external ratings, impacting on the cost and availability of wholesale funding and possible loss of deposits, and also impacting on regulatory capital. The strategy needed to create the illusion of a strong capital base, minimal impairment and robust credit quality. The share price was additionally artificially manipulated through the HBoS programme of returning capital to shareholders and generous dividend policy.

At an early stage High Risk was concerned at the dependency on property values, the risk profile of deals and the level of entrepreneurial lending. Argument to dispel was always centred on the substantial income that was being generated combined with, what was a weak contingency plan in the event of a market shift, being the Bank taking a holding position and not crystallising loss. The relative size of the deals compared to the 1990s was dismissed.

Additionally any argument to demonstrate the sheer magnitude of income generation that was necessary to balance against potential loss within the joint venture and integrated finance portfolios alone (i.e. it takes a lot of fees to plug a hole), was dismissed or simply ignored.

KPIs were aggressively set to incentivise against distress and impairment.

The BoS culture had become a necessity in HBoS.

### **Crisis Time**

By 2005 the group situation had become untenable. Retail was struggling and known to be struggling. The Board in full knowledge of the risk profile in Corporate placed reliance on Corporate to compensate and provide profit and capital through realisation of investments. The reliance wasn't hidden, it was overt and created elitism within Corporate. Credit risk and market risk were given scant regard in larger deals.

Credit was removed from front line competencies.

Simply to stand still required over £20bn of assets that had to be written each year. There had been little progress in winning SME market share in England and Wales. Senior executives within Corporate, the Executive Board and the Board were all fully aware of the risk profile of the portfolio and its dynamics. Performance in Corporate had become predicated in particular on key contacts, "the Group's extended family of entrepreneurs", and the integrated approach. The Corporate model and portfolio was fragile having a dependency on corporate finance deals (which are typically cash flow lends) and commercial property.

Within Risk and Credit there were serious concerns. It was considered unlikely that Corporate would be able to trade out of a prolonged downturn in property markets without some significant "hits".

### 2006 – The Beginning of the End

George Mitchell announced his successor in mid-2005, Peter Cummings. George Mitchell had been strongly resistant to Basel II intrusion and the project was significantly behind plan. Peter was tasked with delivering the Advanced IRB approach waiver for Corporate. It was utter chaos.

The churn in Corporate was increasing, which put even more weight on entrepreneurial, joint venture and leveraged deals. On entering 2006 a correction in the property market was expected but within HBoS, Corporate was under pressure to deliver. Riskier deals were written, including significant secondary retail property deals in Europe. Capital, liquidity and the funding gap had always been a significant risk but the situation was becoming critical. Impairment and distress were clamped down further to maximise Tier 1 capital. It was absolutely essential for HBoS to achieve Advanced Status under Basel II from 1 January 2008 and thereby benefit from the significant reduction in Retail's risk weighted assets (c.£50bn) and the effect that had on regulatory capital. No secret was made of this.

In June 2006 everyone was clearly alert to major economic risks and the developing situation in the USA.

Peter Cummings established the Causality Team in Spring 2006. Corporate High Value cases that migrated into High Risk and Impaired Assets were investigated. They were largely severely distressed on migration. Operational risk was prevalent (including marking of Limits on CBS) and credit risk management and assessment were largely poor. KPMG did not make enquiries of the Causality Team as part of their audit work.

### Tom Angus (Head of Impaired Assets)

Evidence suggests that the Reading Incident was known about well before 2006. However it would appear that Tom Angus on taking up a new role as Head of [High Risk and] Impaired Assets discovered irregularities in August 2006, that later in January 2007 became known as the Reading Incident. The timing of January 2007 is suspicious and may have been to avoid disclosure in the Annual Report and Accounts 2006. The share price at that time was £10 - £11, and although the

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impacts of disclosure would have been substantial, HBoS might have survived the impacts at that time (February 2007)

As explained above, the dynamics of the business were in crisis. The mortgage market had changed dramatically since the merger. The Corporate model and portfolio were of serious concern. The only real light on the horizon was the significantly reduced regulatory capital requirement under Basel II Advanced Status and it was essential for survival for this to be attained. All, including KPMG, were fully aware.

In view of Tom's appointment and the data cleansing exercises, which were exposing Reading Incident cases, **there is evidence to suggest that Paul Burnett, Lynden Scourfield and others were attempting to "hide" Reading Incident cases where there is significant suspicion of money laundering.**

The models that were being introduced into Corporate for Basel II necessitated reconciliation of data, which threw out exception reports resulting in a prolonged data cleansing exercise. Due to the importance of Advanced Status, Peter Cummings had a hands-on oversight role in data cleansing, which fed into all HoFs. The balance of evidence would suggest that Tom Angus strongly suspected irregularities in Reading by June 2006, and that through data cleansing exception reports, Corporate Jet Services Limited and other "hidden" Reading Incident cases had been identified. It would appear that Peter Hickman may have disclosed to the Executive Committee on 31 October 2006 that irregularities in Reading had been identified by Tom Angus.

### Concealment

In June 2006 and subsequently, the Board would not want to recognise a £1bn Impairment Provision. Potential Reading issues were and had been prominent within Corporate Credit Committee Reports. Sir Ron Garrick chaired the divisional Risk Committee, which attended CRC meetings and otherwise received copies of reports and Minutes in relation to the CRC.

**There is evidence to suggest that there was deliberate avoidance of review and audit of MV High Risk connections by Group Credit Risk, GIA and KPMG, none of whom prior to 2007, and despite the relative size of the Reading High Risk portfolio, had reviewed or audited Reading High Risk cases (with the exception of 2 connections in early 2005). KPMG would be fully aware of the underlap between their work and that of Group Credit Risk in relation to MV High Risk connections.**

The Reading Incident was reported to the FSA in March 2007 as a control issue, after the 2006 Annual Results had been announced. On 26 March 2007, the Peer Review team who had been brought in to Reading were provided with strong evidence of money laundering amounting to £11m, involving a number of Reading High Risk cases and David Mills / Quayside. **Criminality was not reported through SARs and was not reported to the FSA. The Peer Team had previously become aware of significant suspicious transactions totalling over £20m on 22 January 2007.**

A final report was subsequently provided to the FSA around the time the Interim Results were announced on 2 August 2007, and the party line of the Reading Incident being a fundamental breakdown in controls at Reading perpetrated by one individual, Lynden Scourfield, with no financial crime implications, was upheld.

It was a "whitewash" exercise; the first of a number. The FSA were seriously and deliberately misled.

KPMG and Group Credit Risk had undertaken significant investigation, and knew that the report submitted to the FSA was incorrect and deliberately misleading. This timing coincided with the securitisation and syndication markets closing and wholesale markets tightening. It was the real beginnings of the financial crisis in the UK.

#### The End

In February 2008 the Annual Report and Accounts for 2007 were announced. The Accounts had been prepared in contemplation of the Rights Issue, which had been strongly influenced by the FSA after they had approved Advanced Status under Basel II.

Disclosure of the Reading Incident at that point in time would in all likelihood have precipitated the collapse of HBoS.

On 29 April 2008, the Rights Issue was announced. The Prospectus was published on 19 June 2008 and on 18 July 2008 the Rights Issue closed. Interim Results for 2008 were announced on 31 July 2008. During this period the Corporate stressed portfolio had grown considerably but was not disclosed to shareholders or the City. Meanwhile the FSA had grave and growing concerns regarding HBoS, which appear to have started in September 2007, when coincidentally they were first furnished with third party evidence to suggest serious irregularities regarding the Reading Incident.

On 17 September 2008 the acquisition by Lloyds TSB was announced. Lloyds' Circular was published on 3 November 2008 and both Prospectuses were published on 19 November 2008. There had been significant growth in Corporate's stressed portfolio, which at that time was reported to the CRC (and divisional Risk Committee) as being £40bn. This was not disclosed in the Prospectuses or subsequent Supplementary Prospectuses, which were published following the HBoS 12 December 2008 Trading Update.

At a basic level, if the Reading Incident had been properly disclosed in the 2007 Annual Report and Accounts then it is unlikely that the Rights Issue would have been capable of proceeding and irrespective of whether the Government stepped in or not at that time to prevent the collapse of HBoS, it is unlikely that a solvent acquisition by Lloyds TSB would have occurred.

## APPENDIX II

### MISLEADING STATEMENTS IN ANNOUNCEMENTS, UPDATES, PROSPECTUSES AND ACCOUNTS

#### 1 August 2007 Interim Results Announcement

*Note: HBoS' share buyback programme and dividend policy were deliberately designed to inflate the share price. The directors and KPMG knew that capital was overstated through the non recognition of distress. Irrespective of that, capital was scarce and was sacrificed to give a false impression to shareholders and investors.*

- "Corporate credit quality remains robust.
- In particular, given the potential for reduced liquidity in the secondary markets, we continue to underwrite and price our originating activity on the assumption that we would be comfortable holding the business on our balance sheet if required to do so.
- Our view on the importance of capital discipline and efficiency at HBoS is unchanged. We will complete our £500m share buyback programme this year. In addition, today's 23% interim dividend increase demonstrates how our capital discipline and efficiency is translated into a higher payout ratio for our shareholders. Above all, today's dividend increase points to the confidence we have in our future.

#### Prospects

- Our strategy is one of measured growth, strong returns, and sound credit quality, with a focus on increasing noninterest income in order to generate significant and sustainable shareholder value.
- Revenues from our investment portfolio have been exceptionally strong in the first half of 2007, and may not be repeated in full in the second half. Nonetheless, we remain confident that overall 2007 will see a substantial increase in the contribution from our investment portfolio and that the portfolio is well positioned to sustain its contribution to earnings in future years."

#### 13 December 2007 Pre-Close Trading Statement

##### Group Overview

- Robust credit trends; Group-wide credit trends remain robust.

Andy Hornby, Group Chief Executive, commented:

"Asset growth has been stronger in the second half than in the first half. Higher levels of lending growth in Corporate (*no where was it explained why*) and a lower share of mortgage principal

repayments in Retail are set to lead to a stronger than forecast level of asset growth for the Group for the full year.

Non-interest income has been maintained at a similar level to the strong performance of the first half. It is thus expected to make a healthy contribution to full year revenues. "

#### Outlook

- "The Group expects to deliver a good full year outcome, in spite of the significantly changed environment in the second half arising from current market liquidity conditions.
- In the short term, we expect the global market dislocation to continue and we will remain prudent in our approach to lending. "

### Annual Report and Accounts: 2007

(Preliminary announcement 27 February 2008)

*[The Rights Issue, influenced by the FSA had already been decided.]*

"The Chairman's lot is a happy one when, as last year, the Annual Report can laud a share price out performance both against the FTSE 100 and the FTSE Banks index. Not so in 2007, where our share price fell some 35%, a performance that was in the middle of the pack, but of little consolation for a bank that seeks to outperform. This year's report will therefore examine with our usual frankness the performance in 2007 and the strategy we are pursuing for our shareholders in 2008.

#### Market dislocation

- If ever the boards of banks, regulators or rating agencies needed a reminder of the importance of strong liquidity and strong capital, the second half of 2007 served as a wake-up call. Seemingly overnight, we moved from a scenario where the economic cycle looked set to play out in a relatively benign way, to one where a credit crunch in the USA rapidly deteriorated into what is, as I write this, a worldwide liquidity dislocation. Banks now know, as in truth they always did, that first and foremost, it is the duty of the Board to ensure that the Group has financial stability and the wherewithal to continue in business profitably.
- For 2008 we will continue to pay careful attention to the importance of both strong capital and strong liquidity and to size our balance sheet to the certainty of both."

#### Chief Executive's Report

- "In our Corporate business we continue to concentrate on markets where we have real expertise and can generate superior returns.
- We accept that capital is owned by our shareholders who expect us to treat it as a scarce resource,.....capital strength is also required to cushion against the shocks that are a periodic feature of banking.
- During 2007, the FSA approved our Advanced Measurement Approach ('AMA') operational risk and Advanced Internal Ratings Based ('AIRB') credit risk waivers. This advanced capital

regime has redefined both the size and nature of the capital resources available to HBOS as well as the level of risk weighted assets. It has not however changed our approach to capital management.

- However [in Corporate], we continued to approach the market selectively, and despite slower secondary markets we continued to sell down to hold levels with which we are comfortable.
- We are planning on the assumptions that market conditions will remain uncertain throughout 2008. For our Treasury & Asset Management division, the key focus for our Treasury team is the management of our funding and liquidity during the financial markets dislocation. We entered this period confident in our funding profile and capital base. This has served us well and we intend to maintain robust liquidity and capital positions going forward. "

#### Corporate Strategy

- The key aspects of our strategy to deliver our overall objective are: Selective asset growth, whilst preserving strong margins and exercising vigilant credit risk management

#### 2007 Performance [Corporate]

- Credit quality remained sound in 2007 although defaults were at a higher level than the historically low figures seen in 2006. *[The considerable impact of the Reading Incident is not explained.]*

#### Risks and Uncertainties [Corporate]

- To mitigate this, we back property entrepreneurs who have a track record of operating through the economic cycle.
- Our commercial real estate exposures are not secured primarily on the value of the collateral but on the strength of the underlying cash flows of the businesses we back.

#### Prospects [Corporate]

- The corporate sector in the UK remains relatively under geared and companies are generally well placed to service increased debt costs.
- Our commercial property portfolio is expected to continue to perform relatively well, partially reflecting our preference for incremental growth in Europe. *[Secondary commercial property was targeted.]*
- In an environment where commercial property prices are expected to remain under pressure our primary focus on cash flow based property transactions, with collateral valuations as support, will continue to drive our risk based decisions.

#### Corporate Governance Comply or Explain Statement

"The Company considers that it has complied throughout the year with all of the provisions within section 1 of the Code, other than provision C.3.1 which recommends that the Audit Committee should comprise solely independent Non-executive Directors....."

#### Going Concern Statement

"The Directors are satisfied that the Group has adequate resources to continue in business for the foreseeable future and consequently the going concern basis continues to be appropriate in preparing the accounts."





## 19 June 2008 Trading Update (as contained in the Rights Issue Prospectus)

*[There are a great many misleading and untrue statements and inconsistencies.]*

"This trading update covers the period from 1 January 2008 to 31 May 2008 and updates the Interim Management Statement published on 29 April 2008."

### GROUP TRADING OVERVIEW

- o "Trading continues to be satisfactory.
- o While HBOS is not immune from the global dislocation in financial markets that is impacting the wider economy and credit conditions, it is on track to demonstrate a resilient performance in 2008.
- o In Corporate we are seeing improved pricing but adopting a cautious approach, and slowing asset growth.
- o We expect to maintain strong capital ratios and, after the rights issue, the Tier 1 ratio is expected to be within the range of 8% to 9% and the Core Tier 1 ratio between 6% and 7%.
- o In a more difficult trading environment, HBOS expects a resilient performance in 2008, which will provide a sound platform for the future.

### Corporate

- o In a slower growth environment we have also planned for lower returns from our Corporate investment portfolio.
- o Lending secured on commercial property investment is based primarily on the quality and diversity of tenant covenants and cashflows.
- o Lending and investment in the housebuilding sector at the end of May 2008 totalled £4.2bn (Dec 2007 £4.0bn), of which £3.5bn was provided in senior debt, £0.3bn in mezzanine, £0.3bn in loan stock and £0.1bn in equity finance. The HBOS housebuilder exposure is mainly to niche sections of the market (including retirement housing, the affluent, urban regeneration and social housing) rather than volume led operators. At this point in the cycle, whilst housebuilder earnings are projected to fall, thereby impacting interest cover, debt safety is underpinned by collateral values including landbanks."

## Rights Issue Prospectus 10 July 2008

Financial Review 2007-2008  
Notes to the Financial Statements 2007-2008

### Agreement to raise income for the Rights Issue

- On 20 April 2008, the Board of Directors announced the Rights Issue and the capital structure. The Rights Issue is intended to raise £1 billion (net of expenses) to strengthen the Group's capital base.
- Together with the establishment on 20 April 2008 of a new target Tier 1 ratio of between 8.0% and 9.0% and a new target core Tier 1 ratio of between 6.0% and 7.0%, these actions will achieve a step change in the capital strength of the Group.
- The Board believes that a stronger capital base is appropriate in current market conditions. The four key objectives of the capital raising are:
  - (a) to reduce the Group's stronger capital ratios
  - (b) to consolidate the Group's strengths in its core markets
  - (c) to mitigate the increased sensitivity on the Group's regulatory capital of change arising from Basel II, and
  - (d) to accommodate the impact of the treasury portfolio fair value adjustments.

### Current trading

- Trading continues to be satisfactory and remains in line with the Group's expectations.

### Dear Shareholder

- Proposed 2 for 5 Rights Issue at 275 pence per Share
- The Corporate division's strategy is asset class management, which is applied to establish selective asset growth while preserving strong margins and exercising vigilant credit risk management. To this end, the Corporate division continues to seek quality opportunities at the right price and with the right partners, concentrating on returns rather than volumes.

## 31 July 2008 Interim Results.

"Lending growth however is being slowed." [Capital constraints were such that it had to be. The true position is grossly misrepresented.]

- "During the first half of 2008, we have set in train a strategy of slower and highly selective growth, continuing to concentrate on markets where we have real expertise and can generate superior returns. Assets continue to be originated on the basis that we are comfortable to hold them on the balance sheet in their entirety, although a proportion of debt or equity positions may be sold down to other market participants if market conditions are supportive.

## Rights Issue Prospectus 19 June 2008

*[Contained 3 years' audited financial statements ended 31 December 2007 and disclosures 2007 with comparatives; 19 June Trading Update.]*

### Background to and reasons for the Rights Issue

- "On 29 April 2008, the Board of HBOS announced the Rights Issue and the Capitalisation Issue. The Rights Issue is intended to raise £4.0 billion (net of expenses), to strengthen the Group's capital base.
- Together with the establishment on 29 April 2008 of a new target Tier 1 ratio of between 8.0% and 9.0% and a new target core Tier 1 ratio of between 6.0% and 7.0%, these actions will achieve a step change in the capital strength of the Group.
- The Board believes that a stronger capital base is appropriate in current market conditions. The four key objectives of the capital raising are:
  - (a) to rebase the Group to stronger capital ratios;
  - (b) to consolidate the Group's strengths in its core markets;
  - (c) to mitigate the increased sensitivity on the Group's regulatory capital of change arising from Basel II; and
  - (d) to accommodate the impact of the Treasury portfolio fair value adjustments.

### Current trading

- Trading continues to be satisfactory and remains in line with the Group's expectations. "

"Dear Shareholder,

- Proposed 2 for 5 Rights Issue at 275 pence per Share
- The Corporate division's strategy is asset class management, which is applied to establish selective asset growth while preserving strong margins and exercising vigilant credit risk management. To this end, the Corporate division continues to seek quality opportunities at the right price and with the right partners, concentrating on returns rather than volumes. "

## 31 July 2008 Interim Results.

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**Prospects**

- Our plans anticipate a worsening in the economic environment, resulting in higher impairment charges. "

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**Prospects**

- Our plans anticipate a worsening in the economic environment, resulting in higher impairment charges. "

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## APPENDIX III

### EVIDENCE IN BOARD AND EXECUTIVE COMMITTEE MINUTES

In considering the following comments made in Minutes, cognisance should be taken of KPMG's role as Auditors and of the requirement for them to exercise professional scepticism when considering the risk aspects of the comments in relation to misstatement and non disclosure in financial statements. [KPMG would review Board Minutes as a matter of course in an audit.]

#### Group Management Board Meeting 20 January 2004

The Minutes demonstrate how focused the Management Board was on delivering results ahead of market median consensus and of reporting impairment provisions that were better than market expectations.

"to increase credibility and the market's likely view of the deliverability of the 20% ROE target" it was important that the first half results for 2004 were "increased by £50m to £80m, and to do this discretionary items would be deferred".

#### Board Meeting 1 March 2005

It is evident from the Minutes that Retail division was under stress and was facing some major challenges, including a 20% fall in the UK mortgage market.

George Mitchell also commented that Corporate's growth target was challenging given the increasing levels of churn. He points out that performance was predicated in particular on key contacts, "the Group's extended family of entrepreneurs", and the integrated approach. He also points out the dependency on corporate finance deals (which are typically cash flow lends) and commercial property.

These are strong warning signs to the Board and additionally not one of them could be in any doubt regarding the risks attaching to the Corporate portfolio.

From a presentation to update the Board in relation to Basel II implementation, the rationale for Advanced Status is quite clearly nothing to do with strengthening risk management but is "the potential for future reductions in regulatory capital and more imminently, the reputational and investor perceptions relative to competitors".

### Executive Committee Meeting 17 May 2005

Basel II implementation was discussed at the Executive Committee Meeting on 17 May 2005. In February 2005 the programme had red flagged as a main consequence of Corporate division and concerns regarding the robustness of the internal credit risk models and their future deployment into business as usual. In addition "It was becoming increasingly clear that data quality was a potential stumbling block".

Those Minutes also confirmed the HBoS strategy to credit risk, which had been and was at that time, an approach "focused on controlling absolute levels of loss".

### Executive Committee Away Days 5 and 6 June 2006

Andy Hornby summarised the Group's strategic weaknesses and the need for the Business Plan 2007 – 2011 to address the shortcomings, which included:

- Lack of sufficient credit risk capabilities;
- Over-reliance on wholesale funding;
- Lack of England and Wales SME share;
- Current Plan showing funding potentially becoming a constrain.

One of Andy Hornby's objectives of the planning process was to achieve double-digit growth in all years. In response Peter Cummings highlighted that in Corporate:

1. Significant further revenue growth would require a major shift in asset growth assumptions;
2. The portfolio had a 30% churn rate so that simply to stand still required c.£24bn of assets to be written each year;
3. As there was a very low share of the SME market then a step-change in performance depended on being able to originate larger deals;
4. In seeking to lead larger [syndicated] deals would have a material capital undertaking risk, unless or until the group's capital market capabilities were further advanced;
5. Post merger push in trying to increase market share "had been focused excessively on quick wins, and had largely become focused on commercial property";
6. To achieve the rate of growth Hornby was looking for required additional people capabilities in origination, where Corporate's strengths did not lie, and more risk would need to be taken in some asset-backed environments;
7. In particular, "Any increased growth was likely to increase the group's exposure to commercial property.";
8. A cyclical downturn in commercial property would necessitate a hold situation and work out over time.

Peter Cummings recommends high single digit growth to lessen the risks and particularly those relating to large scale lending against purely speculative property development deals. However a

major assumption to that recommendation and the deals that had already been struck was that there would be no material correction in the commercial property market.

With regard to International, a main target was increasing Corporate's market share in Europe. Traditionally this had been through leveraging international relationships linked to the North Sea Oil industry, which had been strongly asset backed. To move away from that was a high risk strategy.

The Minutes additionally include comment on excess levels of personal indebtedness in Retail and Corporate. Benny Higgins comments on Retail point to a floundering strategy and the need for a complete rethink. His initial address starts with a strong warning in relation to future impairments. Benny Higgins' summary of key Retail objectives, lacks any explanation as to how the objectives will be achieved, and is more a wish list that might deliver Andy Hornby's growth aspirations e.g. "SME was a key cross Divisional imperative". Of additional concern in Benny Higgins' comments is the linkage between unsecured personal loans and "looking hard at" PPI sales.

#### **Executive Committee Away Days 31 October and 1 November 2006**

Peter Hickman appears to alert the Executive Committee to potential irregularities in Reading and a requirement for large provisioning.

Additionally in an indirect reference to the Reading Incident, it is commented in relation to Corporate "the importance of limit management".

towards a conclusion that the Group should hold more property assets."

#### **Board Meeting 22 May 2007**

Significant sales issues in Retail were highlighted and in particular the ongoing shortfall in the mortgage business.

The Reading Incident was formally minuted as being a control weakness within Corporate division, which would lead to a significant provision during the year.

It was minuted that there were major challenges in relation to Corporate's Advanced IRB approach waiver application and in particular the General Corporate Models.

The Quarterly Key Credit Trends report showed that there were indications that the Corporate credit cycle was turning. A market correction had been expected for some time. It was commented that there it was difficult to track stress in the commercial property portfolio.

The minutes confirm that the strategy at that time was still to avoid distress and impairment ("primary focus on controlling absolute levels of loss").

**Executive Committee Meeting 18 September 2007**

John Giddens confirmed that the FSA had approved the 2008 approach to meet the wider  
capital requirements. There were specific and conditions still being to the system.

**Executive Committee Meeting Days 29 and 30 October 2007**

In view of the continuing tightening of the money markets, the draft Funding Plan was discussed.  
Key assumptions were that the interbank market would remain at 1% LIBOR and that there would be  
sufficient capital and funding available to cover the 2008 period. There was a focus on the  
situation of capital conditions in September 2008 had shown a very uncomfortable situation  
which was unlikely to improve. It was noted that specific issues might prove to be difficult to cope with.

**Board Meeting 1 April 2008**

John Giddens confirmed that economic outlook was that there was no prospect of any further  
improvement in market conditions in the balance of the year.

**Executive Committee Meeting 21 April 2008**

This meeting was held in view of the FSA and the announcement of the Rights issue on 19  
April 2008.

The minutes include the following comments from John Giddens:

"The company forecast full year (2008) position with respect to Target Tier 1 Capital was  
unacceptable."

"I had requested a contribution to the interim Management Statement that was released on 29 April  
2008 and which outlined the Rights issue."

**Board Meeting 23 May 2008**

Following Board approval of the FSA 2008 risk assessment and Risk Mitigation Plan, the substance  
of the review was summarized.

"The Group was regarded as presenting a high systemic risk, less than of its reach and relative  
importance."

Specific areas of concern included credit risk, capital, funding and liquidity.



### **Executive Committee Meeting 18 September 2007**

Peter Hickman confirmed that the FSA had approved the AIRB approach credit risk waiver application. However there were significant conditions attaching to the waiver.

### **Executive Committee Away days 25 and 26 October 2007**

In view of the continuing tightening of the money markets, the draft Funding Plan was discussed. Key assumptions were that securitisation markets would reopen in H1 2008 and that there would be sizeable capital and funding issuance in every non-holiday month. Stress testing of the base case for a re-run of similar conditions in September 2008, had shown "a very uncomfortable situation", which was survivable. However "HBoS specific issues might prove to be difficult to cope with".

### **Board Meeting 1 April 2008**

Mike Ellis confirmed that economic belief was that there was no prospect of any material improvement in market conditions in the balance of the year.

### **Executive Committee Meeting 22 April 2008**

This meeting was immediately prior to the AGM and the announcement of the Rights Issue on 29 April 2008.

The minutes include the following comment from Mike Ellis:

**"The current forecast half year (2008) position with respect to Target Tier 1 Capital was unacceptable"**

That comment is contradictory to the Interim Management Statement that was released on 29 April 2008 and which announced the Rights Issue.

### **Board Meeting 28 May 2008**

Following Board approval of the FSA ARROW risk assessment and Risk Mitigation Plan, the outcome of the review was summarised.

**"The Group was regarded as presenting a high systemic risk, because of its reach and relative importance".**

**Specific areas of concern included credit risk, capital, funding and liquidity.**

Personnel within the Quarter, the Credit Control system and highlighted that there were signs of distress in the Retail and Corporate portfolios, and that the situation was having a bear impact on M&A.

At this point, the Board would have been reviewing a report of the 3 months results to 31 May 2008 which, comprising the trading results released on 28 June 2008 and formed part of the Rights Issue Prospectus.

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## APPENDIX IV

### CAPITAL REQUIREMENTS EXPLAINED

This is a very simple and high level walkthrough, but should be sufficient for the level of understanding that is required for the purposes of this report and potential jury evidence

#### Introduction

Basel is an international standard for the amount of capital that banks need to put aside to deal with current and potential financial and operational risks, or in other words the amount of capital that is required to absorb a reasonable level of losses before becoming insolvent. Banks are required to set aside more capital for higher risk exposures

Applying minimum capital adequacy ratios serves to protect depositors and promote economic stability

Risk based capital or regulatory capital is differentiated into two categories / standards. Tier 1 capital and Tier 2 capital, and is used by regulators to measure a bank's capital adequacy

Tier 1 capital is the best form of capital and is capital which can absorb losses without a bank being required to cease trading e.g. ordinary share capital. Tier 2 capital provides a lesser degree of protection to depositors and is capital which can absorb losses in the event of insolvency

#### Addressing the Criticisms

Basel I came into effect in 1988. A criticism of the regime was that it was too simple in application and that it was easy to achieve significant capital reduction with little or no risk transfer i.e. Basel I was, at a basic level, not sensitive to risk.

It had another fault. A material element of regulatory capital is what is called Core Tier 1 capital (the first cut of Tier 1 capital), which basically is a company's profit and loss reserves. Under Basel I, calculation of Core Tier 1 capital could be manipulated through restricting Specific Impairment Provisions, thus maximising profit and loss reserves and maximising regulatory capital.

As a result of the way that the minimum capital requirement was calculated under Basel I, HBOS through incentivising non-recognition of distress and in particular restricting the Specific Impairment provision, significantly improved their Tier 1 capital.

Basel II was introduced to address the criticism relating to risk aspects. The effective date in the UK for implementation was 1 January 2008 and as previously explained in 2004 all major banks in the

UK including HBoS commenced preparations for Basel II and the submission of waiver applications for Advanced approaches.

Basel II links capital requirements more tightly to the risks that banks incur. This was intended to have two motivational effects

- Better risk management; and
- Safer, less risky credits (improved risk weightings).

It should be pointed out that until August 2008, the above benefits were not promoted in Corporate or even commented upon. What was strongly promoted by Peter Cummings prior to August 2008 was that it was a regulatory requirement, that Advanced Status was non-negotiable and that Corporate would need to be live to the cost of capital when doing deals. Within High Risk & Impaired Assets, this translated to churning High Risk connections back to the Good Book thus improving internal credit ratings.

There was a very high degree of scepticism. We had seen "credit" removed from the performance competencies of the front line during the Corporate journey. IAS Provisioning and distress status were overtly manipulated. Nexus was unreliable and subjective. It was patently clear that capital was going to be manipulated.

#### More of the Theory

Under Basel II, the capital requirements comprise two elements (Pillar 1 and Pillar 2), which are the regulatory capital requirements for credit, operational and market risks (Pillar 1) and any additional capital requirements identified through a bank's Internal Capital Adequacy Assessment Process (ICAAP), which are not captured under Pillar 1 e.g. to mitigate against concentration risk. The total minimum regulatory capital requirement is set by the FSA taking into account the ICAAP assessment. Basel II minimum regulatory capital requirements were designed to:

- Reduce risk of failure by cushioning against losses;
- Provide continuing access to financial markets to meet liquidity needs;
- Provide incentives for prudent risk management.

Basel II treated banks differently depending on the "sophistication" of their risk management systems.

Capital requirements are expressed as a percentage called the capital adequacy ratios and are Tier 1 and Tier 2 capital, plus combined, expressed as ratios of Risk Weighted Assets.

Under Basel I, Risk Weightings were determined by the regulator.

Under Base II Advanced approach for credit risk capital, the RWA are determined using banks' own internal credit ratings. Fundamental to all banks is or should be the management of credit risk. Credit risk was the most significant component of HBoS' Pillar 1 capital requirement. (Basel II Pillar 1



allowed banks to adopt different approaches / methodologies to determine their minimum regulatory capital requirements to support their exposures to credit, market and operational risks. There are three approaches, but for HBoS it was important to have approval for the adoption of the Advanced IRB approach.)

In theory under the Advanced IRB approach, Tier 1 capital could no longer be manipulated through avoidance of Specific Impairment Provisions. The HBoS Corporate response was to manipulate internal ratings / distress instead. RWA and Expected Loss calculations were thus understated meaning that the capital adequacy ratios were overstated.

#### **HBoS and Basel II in more Detail**

Work first began on preparing for Basel II in 2004. In Corporate division this required significant levels of investment in the development of credit risk rating tools, processes, governance and operations to support the Basel II Accord, and in particular the Advanced IRB approach. At no point was it explained within the High Risk & Impaired Assets arena as being from the point of view of improving credit risk management. The concern and focus were entirely on the effect it would have on capital adequacy. From a market reputation and perception perspective, it was not an option not to have the AIRB approach for credit risk regulatory capital in Corporate.

The AIRB approach is the most sophisticated approach. It allows banks to use their own internal assessment of probability of loss and default and the quantum of loss, to determine RWA values. To do this internal models are built to generate ratings (Probability of Default, Loss Given Default, Exposure at Default and Expected Loss) for products within the asset classes (loans). The Expected Loss is a combination of PD, LGD and EAD. The risk weightings that are derived are applied to credit risk exposures. The risk weighted asset itself reflects the Unexpected Loss in relation to the exposure.

Corporate division built an internal ratings model for credit risk called Nexus. Analysis of an obligor's financial statements together with qualitative assessment were then calibrated to the historic statistical data of default to give a Probability of Default rating. Similarly Loss Given Default was generated from historical statistical data of loss. The Expected Loss was thus heavily dependent on historic trending and data. If that historic data had been manipulated to underestimate default and contain loss, which HBoS had previously done, then Expected Loss will also be underestimated. Additionally for internal ratings to be reliable, they require "through the cycle" historic data, which Corporate did not have. Anything they did have was distorted due to non recognition of distress.

The AIRB approach for credit risk regulatory capital also changes the way in which the regulatory capital is calculated. Whereas under Basel I, Tier 1 capital could be influenced by manipulating the Specific Impairment charge (with the general [collective] charge being part of Tier 2 capital), under Basel II, it is the Expected Loss, which is important. The excess of Expected Loss less the accounting Impairment Provision is deducted 50:50 between Tier 1 capital and Tier 2 capital.

If the internal ratings improve, then RWA decrease and EL reduces, hence the capital adequacy ratios improve.

In terms of Corporate division this meant in addition to flawed historic data and subjective data input, there was another "simple fix" of reducing Past Due and High Risk exposures.

This desire ("instruction") wasn't hidden from anyone. Paul Burnett directly referred to discussions with Peter Cummings on the subject (at which it was probable that Hugh McMillan and others would be present).

To illustrate the point of how internal models can be manipulated to reduce capital requirements, a BIS study in 2013 required 15 banks to run their risk weighting models on an identical sample portfolio. The banks were spread and reported capital requirements varying from €3.4m to €34.1m for the same portfolio.

From: Harris, Sue (Group Audit Director)

Sent: 17 July 2013 12:48

To: Masterton, Sally (Credit Intelligence); Ahern, Richard (Group Audit)

Cc: 'gillian.eastwood@freshfields.com'; Martin, Gavin; 'Tim.Hurley@thamesvalley.pnn.police.uk';

'Mick.Murphy@thamesvalley.pnn.police.uk'; Hartridge, Michael (Group Legal, Risk Legal & Secretariat)

Subject: Re: Bringing You Up To Speed

Dear Sally

I have spoken this morning to Tim Hurley who I understand also spoke to you yesterday after receiving your email

Tim has been very clear that TVP has not asked you to do any more work. You are therefore entirely free to undertake work in the normal way as requested by LBG. Tim has also confirmed that if there is anything further TVP needs they will make that known to LBG and we will decide how best to handle it. This is entirely the proper way for TVP to work with LBG so that we direct our own employees in their work activities.

This is good news Sally because it now means that you can operate in a business as usual mode with management direction. Given this Sally it is important that you now complete please the tasks we have previously requested.

As you point out below cutting and pasting Spayside Angling and Gullen is quick, so please complete that today and send it to us.

You have also previously agreed to let us have cut and paste of your statements again, please provide those today.

In respect to the governance issue you raised with me on Friday, please set out what you have found and copies of the documents you have searched for in the shared drives. Please can you confirm that no documents in this respect were passed to TVP last week.

We will consider other tasks once these are completed. Please note that we are not asking you to do any other research at this time, in order that you are freed up to complete these tasks without any further delay.

Many thanks

Kind regards

Sue

From: Masterton, Sally (Credit Intelligence)

To: Ahern, Richard (Group Audit)

Cc: Harris, Sue (Group Audit Director); gillian.eastwood@freshfields.com

<gillian.eastwood@freshfields.com>; Martin, Gavin; Hurley Tim <Tim.Hurley@thamesvalley.pnn.police.uk>;

Murphy Mick <Mick.Murphy@thamesvalley.pnn.police.uk>

Sent: Tue Jul 16 17:29:56 2013

Subject: RE: Bringing You Up To Speed

H. Richard

Yes I'm good. And you?

Tim Hurley hasn't as yet debriefed Mick in relation to my interview / discussions, which I outlined in bullet points to you in my emails last week. There are however clear Hornet issues. Once Tim has debriefed Mick he will then decide whether a further statement should be drafted. There are some serious Corporate Governance Reporting Audit Disclosure and Project Windsor issues that Tim needs to consider and which

16/10/2013

The first part of the document discusses the importance of maintaining accurate records of all transactions. It emphasizes that every entry should be supported by a valid receipt or invoice. This ensures transparency and allows for easy verification of the data.

Additionally, it highlights the need for regular audits to identify any discrepancies or errors. By conducting these checks frequently, potential issues can be caught early, preventing them from escalating into major problems.

The second part of the document focuses on the role of technology in streamlining financial processes. It suggests implementing accounting software that can automate repetitive tasks, such as data entry and reconciliation. This not only saves time but also reduces the risk of human error.

Finally, it stresses the importance of staying up-to-date with the latest financial regulations and tax laws. Consulting with a professional advisor can help ensure that the organization remains in full compliance, avoiding any penalties or legal complications.

In conclusion, effective financial management is essential for the long-term success of any business. By adhering to the principles outlined in this document, organizations can ensure their financial records are accurate, secure, and compliant.

It is recommended that all staff members involved in financial operations receive proper training and guidance. This will help them understand their responsibilities and contribute to the overall financial health of the company.

The following table provides a summary of the key points discussed in the document. It serves as a quick reference for anyone reviewing the information.

Topic	Key Points
Record Keeping	Use receipts and invoices; maintain accurate records.
Audits	Conduct regular audits to catch errors early.
Technology	Implement accounting software to automate tasks.
Compliance	Stay up-to-date with regulations and tax laws.

For more information on financial management best practices, please refer to the attached resources. These include a list of recommended accounting software and a guide to common financial reporting standards.

We encourage you to reach out to the finance department if you have any questions or need further assistance. Our goal is to provide you with the support and information you need to succeed.

Thank you for your attention to this important document. We look forward to your feedback and continued collaboration.

Sincerely,  
 [Signature]  
 Finance Director