BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

FCA
FINANCIAL CONDUCT AUTHORITY

Report into the FSA's enforcement actions following the failure of HBOS

By Andrew Green Q.C.,
assisted by James Segan and Simon Pritchard of Blackstone Chambers

November 2015

Contents

A. Introduction: Scope & Conclusions

1. This Report assesses "*the reasonableness of the scope of the FSA's enforcement investigations in relation to the failure of HBOS*" in the period from 1 October 2008 (the date identified as being that of the failure) to 12 September 2012 (the date of the Final Notice issued to Peter Cummings), which is referred to below as the '*Review Period*'(1). In assessing "*reasonableness*", I have been asked to give a personal assessment based upon my experience as a financial services practitioner, rather than applying any of the formulations of that concept used in judicial review.

2. The FSA's Enforcement and Financial Crime Division ('Enforcement') conducted two investigations arising from the failure of HBOS: (1) an investigation into the conduct of Peter Cummings in relation to his activities as Chief Executive Officer of the Corporate Division (this started with a Memorandum of Appointment of Investigators dated 23 March 2009); and (2) an investigation of the Bank of Scotland ('BoS') in relation to its management and control of the Corporate Division (this started with a Memorandum of Appointment of Investigators dated 27 May 2011 i.e. over two years after the start of the investigation of Mr Cummings)(2). As a result of these two investigations, (1) disciplinary and prohibition proceedings were brought by the FSA against Mr Cummings, resulting in a financial penalty of £500,000 and a partial prohibition; and (2) disciplinary proceedings were brought against BoS, resulting in a public censure (no financial penalty having been sought)(3).

3. Mr Cummings was the only member of the former senior management of HBOS ever investigated by Enforcement in relation to the failure of the bank, and the only member of the former senior management against whom disciplinary and/or prohibition proceedings were brought(4). Inevitably, the '*public message*' conveyed was that Mr Cummings was the only former senior manager of this failed bank whom the FSA considered it appropriate to make the subject of enforcement action. It is clear, and was emphasised by a number of interviewees, that the '*public message*' conveyed by enforcement action was regarded as an important consideration by the FSA when deciding upon the targets of enforcement investigations.

4. An investigation is the starting point for enforcement action, and can then lead to disciplinary and/or prohibition proceedings depending on the information obtained during that investigation. Without an investigation into any individual other than Mr Cummings, it was highly likely that no-one other than Mr Cummings would be the subject of disciplinary and/or prohibition proceedings. A key issue for this Report is, therefore, to assess whether or not it was reasonable that Mr Cummings was the only member of the former senior management of HBOS to be investigated during the Review Period.

5. My assessment is not conducted on the basis of the information now known. It is not an exercise in hindsight, but is conducted on the basis of the information known to the FSA during the Review Period. While the Terms of Reference also invite me to provide "*an opinion…as to*

(1) See Terms of Reference, paragraphs 2b and 4f. It is apparent from the Terms of Reference that this Report was originally intended to be published by the FCA and PRA as part of a wider report into the failure of HBOS. Since publication of the Terms of Reference, the FCA and PRA have decided that this Report is to be published as an independent report.
(2) BoS was the subject of the enforcement action because, as a result of various corporate reorganisations in 2006 and 2007, the business of the Corporate Division (among others) was conducted through BoS.
(3) For the purpose of this Report: (1) the phrase '*enforcement action*' refers to any action which can be taken by Enforcement, including an investigation and subsequent disciplinary and/or prohibition proceedings; (2) the phrase '*disciplinary proceedings*' refers to proceedings brought under sections 66 or 206 of the Financial Services and Markets Act 2000; and (3) the phrase '*prohibition proceedings*' refers to proceedings brought under section 56 of that Act.
(4) In this Report references to '*former senior management*' or '*former senior managers*' are to the senior managers of HBOS prior to or at 1 October 2008.

whether the regulators should consider afresh whether any other former members of HBOS's senior management should be subject to an investigation with a view to prohibition proceedings"[5], the opinion I have expressed in this regard is, as I explain below (section D(9)), based on my judgment as to the adequacy of the consideration in fact given by the FSA to these issues in the past.

6. This Report does not include an assessment of the decisions made by the Regulatory Decisions Committee ('RDC') during the Review Period, and does not therefore assess the reasonableness of the RDC's decisions (1) to issue Mr Cummings with a Warning Notice dated 3 June 2011 and a Decision Notice dated 22 May 2012, (2) to withdraw the Decision Notice issued to Mr Cummings (following his threat to start judicial review proceedings), and (3) to issue BoS with a Warning Notice dated 22 September 2011. Nor does this Report assess the adequacy of the actual investigations conducted by Enforcement of Mr Cummings and BoS.

7. For the purpose of producing this Report, a substantial volume of documentation has been provided by the FCA; and interviews have been conducted with 15 people, as identified in the list at annexe 1, each of whom (apart from Mr Cummings) was employed by the FSA at various times during the Review Period.[6] These interviews are referred to below as 'Report interviews'. A number of the interviewees also provided written statements. The Terms of Reference and the Protocols which governed the production of this Report are attached at annexe 2. In accordance with the Protocols, those who are potentially criticised in this Report have been given an opportunity to make representations in relation to such potential criticisms (by being provided with a draft of the Report); and those representations have been considered when producing the final version of this Report.

8. My conclusion, in summary, is that the scope of the FSA's enforcement investigations in relation to the failure of HBOS was not reasonable. The decision-making process adopted by the FSA was materially flawed; and the FSA should have conducted an investigation, or series of investigations, wider in scope than merely into the conduct of Mr Cummings and the Corporate Division.

9. In reaching this conclusion, the key points are as follows:

   (a) The FSA failed to conduct a reasonable decision-making process in the period between December 2008 and 26 February 2009[7]. In particular, the only person whose possible misconduct was given proper consideration for investigation during this period was Mr Cummings (in relation to the Corporate Division); the FSA gave no proper consideration to the investigation of any other individuals including former members of the Board (such as the former Group Chief Executive Officer, Andy Hornby, and the former Chairman, Lord Stevenson); and the FSA gave no proper consideration to an investigation of HBOS itself.

   (b) The FSA, in the period after 26 February 2009, failed properly to consider the scope of the existing investigation. After 26 February 2009, the losses and impairments in other areas of the failed bank, particularly the International and Treasury Divisions, were of such magnitude that the FSA should have considered other potential subjects for investigation including, in particular, the former Chief Executive Officers of the International and Treasury Divisions. It failed to do so.

(5) See Terms of Reference, paragraph 4f.
(6) In publishing this Report, the FCA and PRA have decided that those individuals who are current or former FSA/FCA employees and were, at the time of the events in question, below the level of Director are not to be identified by name in this Report. This was contrary to my view which favoured transparency. The consequence is that fictitious names have been used for all such employees below the level of Director. Annexe 1 identifies those names which are fictitious.
(7) This is the period from when the FSA first appears to have considered enforcement action in relation to the failure of HBOS (early December 2008) to the date of the Enforcement Referral Document relating to Mr Cummings (26 February 2009).

(c) The FSA should have investigated more broadly than simply Mr Cummings and the Corporate Division given, in particular, that it was aware (both in December 2008, and thereafter) that the problems within the bank at the time of its failure extended well beyond Mr Cummings and the Corporate Division, and given the public interest in suitably targeted enforcement action following the failure of this systemically important bank. The failure to investigate more broadly was not reasonable.

(d) The FSA, at a minimum, should also have investigated Mr Hornby from early 2009 (i.e. in addition to Mr Cummings), and the failure to do so was not reasonable. Further, the decision in March 2010 not to investigate Mr Hornby, even though the FSA rightly considered that the statutory threshold test for investigating his possible misconduct was met, was not reasonable.

10. On the positive side:

(a) The FSA's decision, in February 2009, to investigate Mr Cummings was a reasonable one.

(b) The FSA's decision, in April 2011, to investigate BoS was a reasonable one. However, the fact that it was not until early 2011 that the FSA first gave proper consideration to enforcement action against the firm (and even then only in relation to the Corporate Division) highlights the inadequacy of the FSA's decision-making process in the period leading up to 26 February 2009.

(c) The FSA's decisions, in March and September 2012 respectively, to compromise the disciplinary and/or prohibition proceedings brought against BoS and Mr Cummings were reasonable. Those decisions reflected reasonable judgments as to what was realistically achievable by way of penalty in each case and the inherent litigation risks.

11. Given the inadequacies in the FSA's decision-making processes (as referred to in paragraph 9 above), the FCA and/or the PRA should now consider whether any other former senior managers of HBOS (including, but not limited to, Mr Hornby and Lord Stevenson) should be the subject of an enforcement investigation with a view to prohibition proceedings. There is plainly a public interest in this being considered afresh. In a Report interview, one senior former FSA employee expressed the view that "*the people most culpable were let off*"; he said that in his view those people were the former Group CEO and Chairman (i.e. Mr Hornby and Lord Stevenson); and he fairly accepted that "*there was something unsatisfactory in the [initial] referral decision-making process whereby these people were not even considered*" (i.e. for investigation). It is appropriate for this now to be considered afresh by the FCA and/or PRA(8).

12. Having summarised the mistakes that were made by the FSA, it is nevertheless important to put them in context. In particular:

(a) These mistakes were made by people working under very considerable pressure in the unique context of the global financial crisis, with the result that they were dealing with the regulatory consequences of the failure of a number of systemically important UK institutions in addition to dealing with their normal regulatory workload. As Sir Hector Sants said in his Report interview: "*…the FSA was stretched almost to breaking point in terms of its resources in this period*"(9).

(8) On 1 April 2013, the FCA and the PRA succeeded the FSA as the entities responsible for regulating the financial services industry. The FCA thereby became responsible for the conduct supervision of all regulated financial firms; and the PRA became responsible for prudential supervision. It follows that, during the Review Period, the FSA was responsible for considering enforcement action arising from the failure of HBOS; but that such responsibility now lies with the FCA and/or the PRA.

(9) Although referred to here as Sir Hector Sants, he had not been knighted at the time of the events set out in this Report.

(b) These mistakes were made in the context of a regulatory scheme that was ill-suited to the identification of appropriate subjects for enforcement action in circumstances where a banking institution had failed; and this certainly made the task of those involved in the decision-making process a difficult one. As explained in section B below, the FSA's regulatory guidance stated that it would only take disciplinary action against an individual where there was evidence of '*personal culpability*'. In the context of a substantial multi-divisional company such as HBOS, where strategy was frequently the result of collective decision-making over an extended period of time, it was inevitably difficult to identify a particular individual whose conduct evidenced '*personal culpability*'.

(c) It was fairly emphasised by a number of Report interviewees that disciplinary and prohibition proceedings against senior managers were viewed as being extremely hard to win. It appears that, in consequence, there was considerable caution within the FSA before committing substantial resources to a complex investigation which might not lead to a successful disciplinary or prohibition outcome. By way of example, the Manager in Enforcement who led the investigation into Mr Cummings said in his Report interview that: "*we satisfy ourselves that we have a reasonable prospect of succeeding and getting a good result from an investigation before we investigate*". This caution did not, however, justify pursuing only Mr Cummings.

(d) Having conducted the Report interviews, the impression I formed of those individuals working within the FSA at the time was that they were committed and hard-working.

13. The remaining sections of this Report address the following topics:

(a) Section B: The Regulatory Scheme

(b) Section C: The Relevant Factual Background

(c) Section D: Assessment of the scope of the FSA's enforcement investigations

(d) Section E: Recommendations

B. The Regulatory Scheme

B.1 The FSA's Regulatory Objectives & the Principles of Good Regulation

14. During the Review Period (1 October 2008 to 12 September 2012), the FSA's '*regulatory objectives*' were set out in section 2(2) of the Financial Services and Markets Act 2000 ('the Act'), and included: (1) maintaining confidence in the UK financial system; (2) securing the appropriate degree of protection for consumers; (3) the reduction of financial crime; (4) public awareness(10); and (5) financial stability(11).

15. Section 2(3) of the Act set out factors (known as the '*Principles of Good Regulation*') to which the FSA was required to have regard when discharging its general functions. The '*Principles of Good Regulation*' included the following: (1) "*the need to use its resources in the most efficient and economic way*"; and (2) "*the responsibilities of those who manage the affairs of authorised persons*" (reflecting the fact that senior management responsibility was an important feature of the regulatory scheme). From 12 October 2011, section 2(3) was amended so as to include "*the desirability of enhancing the understanding and knowledge of members of the public of financial matters*" (including the UK financial system).

16. Section 2 of the Act required the FSA (so far as was reasonably possible), in discharging its '*general functions*', to act in a way which was compatible with the '*regulatory objectives*', and to have regard to the '*Principles of Good Regulation*'. The '*general functions*' were those of making rules, issuing codes, giving general guidance and determining general policy and principles (section 2(4))(12). Although the '*general functions*' did not expressly cover the FSA's conduct of enforcement action, the FSA, when considering whether to bring enforcement action and when conducting any such action, would nevertheless have regard to both the '*regulatory objectives*' and the '*Principles of Good Regulation*'(13).

B.2 Requirement for '*approval*' of individuals

17. Central to the regulatory scheme created by the Act were the requirements that (1) any firm conducting a regulated activity had to be authorised by the FSA (i.e. an '*authorised person*'), and (2) those members of an authorised firm responsible for performing '*controlled functions*' had to be approved by the FSA (i.e. an '*approved person*'(14)).

(10) A regulatory objective from 18 July 2001 until 11 October 2010.
(11) A regulatory objective from 8 April 2010.
(12) Such rules, codes, guidance and principles were set out in '*the FSA Handbook*', referred to below as 'the Handbook'. All of the provisions in the Handbook referred to below were in force throughout the Review Period i.e. 1 October 2008 to 12 September 2012.
(13) In an FSA document entitled '*Written evidence from the Financial Services Authority*' dated 18 January 2013, provided to the Parliamentary Commission on Banking Standards, the FSA was asked (Question 23) to provide "*a summary of how decisions are taken on whether to proceed [to bring enforcement action] based on the likely cost including the role of the cost benefit analysis*". The response included the following statement: "*In considering whether to commence or continue any Enforcement action, we take a risk-based approach: this includes considering our Regulatory Objectives (ie Market confidence, financial stability, the protection of consumers and the reduction of financial crime), the Principles of Good Regulation and our Referral Criteria.*" The Referral Criteria were the listed factors set out in the FSA's 'Guidance Note' to the Enforcement Referral Document (this being an internal FSA document recording the decision to refer a matter to Enforcement for investigation; paragraph 41 below). Although the FSA's statement as quoted above was made in January 2013, it appears to encapsulate the FSA's approach during the Review Period.
(14) When an approved person left the firm at which he was performing a particular controlled function for which approval had been obtained, that approval lapsed.

18. Section 59 of the Act was the statutory provision whereby the FSA ensured that certain '*controlled functions*' were carried out only by those persons '*approved*' by the FSA. A '*controlled function*' had to fulfil one of three conditions set out in section 59, one such condition being that "*the function is likely to enable the person responsible for its performance to exercise a significant influence on the conduct of the authorised person's affairs, so far as relating to the regulated activity*" i.e. a '*significant influence function*' (a person performing such a function frequently being referred to as a 'SIF').

19. The '*controlled functions*' were identified in the FSA Handbook (the section entitled '*Supervision Manual*', or 'SUP'), and were identified by the abbreviations 'CF1', 'CF2' etc. Certain of those '*controlled functions*' were identified as being '*significant influence functions*'. In particular, certain '*governing functions*' (including 'CF1' – '*Director*'; 'CF2' – '*Non-executive director*'; and 'CF3' – '*Chief executive*') were identified as '*significant influence functions*'. It therefore follows that (for example) Mr Cummings (a director) was performing a significant influence function and required '*approval*' under section 59; and the same was true of Mr Hornby (a director and Chief Executive) and Lord Stevenson (a non-executive director).

20. Section 61 of the Act provided that the FSA, on receipt of an application for approval for an individual to perform a '*controlled function*', was only able to grant the application if satisfied that the candidate for approval was a '*fit and proper*' person to perform the function(s) to which the application related. The Act did not define what was meant by '*fit and proper*'. However, the FSA identified the criteria to be applied by the FSA (in the '*Fitness and Propriety*' section of the Handbook, 'FIT') when considering whether a person was '*fit and proper*' to perform a '*controlled function*' as (1) honesty, integrity and reputation, (2) competence and capability, and (3) financial soundness. The burden was on the firm (which would make the application with a view to obtaining approval of the particular person), to prove that the person to whom the application related was '*fit and proper*'. The FIT criteria were also relevant when assessing the continuing fitness and propriety of approved persons.

B.3 Conduct of approved persons

21. The Act created a system of standards of conduct, backed by disciplinary powers, applicable to approved persons. The foundations of this system were the '*Statements of Principle*' issued by the FSA, setting out the conduct expected of approved persons. The '*Statements of Principle*' were supported by a '*Code of Practice*' issued by the FSA, as guidance, for the purpose of helping to determine whether or not a person's conduct complied with a statement of principle.

22. It was section 64 of the Act which gave the FSA power to issue '*Statements of Principle*' and the '*Code of Practice*'; and, in the exercise of this power, the FSA published both '*Statements of Principle*' and a '*Code of Practice*' in the Handbook (in the section entitled '*Statements of Principle and Code of Practice for Approved Persons*', or 'APER'). Approved persons were obliged to comply with the '*Statements of Principle*' (section 64).

23. There were seven '*Statements of Principle*'. The first four of those '*Statements of Principle*' applied to all approved persons; and the final three related specifically to SIFs:

    (a) Principle 5 provided that: "*An approved person performing a significant influence function must take reasonable steps to ensure that the business of the firm for which he is responsible in his controlled function is organised so that it can be controlled effectively.*"

    (b) Principle 6 provided that: "*An approved person performing a significant influence function must exercise due skill, care and diligence in managing the business of the firm for which he is*

responsible in his controlled function." The Final Notice issued to Mr Cummings identified a breach of Principle 6.

(c) Principle 7 provided that: "*An approved person performing a significant influence function must take reasonable steps to ensure that the business of the firm for which he is responsible in his controlled function complies with the relevant requirements and standards of the regulatory system.*"

24. The '*Code of Practice*' (APER 3.1.4G) stated that an approved person would only be in breach of a Statement of Principle where he was '*personally culpable*'. "*Personal culpability arises where an approved person's conduct was deliberate, or where the approved person's standard of conduct was below that which would be reasonable in all the circumstances.*" And, as regards SIFs (APER 3.1.8G): "*The FSA will be of the opinion that an individual performing a significant influence function may have breached Statements of Principle 5 to 7 only if his conduct was below the standard which would be reasonable in all the circumstances.*"

B.4 Disciplinary proceedings: '*misconduct*' of an approved person

25. Section 66 of the Act enabled the FSA to bring disciplinary proceedings against an approved person (1) if it appeared to the FSA that the person was '*guilty of misconduct*', and (2) if the FSA was satisfied that it was appropriate to bring such proceedings in all the circumstances. The section provided that a person was '*guilty of misconduct*' if, while an approved person, (1) he failed to comply with one of the '*Statements of Principle*', or (2) he had been '*knowingly concerned*' in a breach by the authorised firm of a requirement imposed on the firm by or under the Act.

26. The Handbook stated (in the section entitled '*Decisions, Procedures and Penalties*', 'DEPP') that "*the FSA may take disciplinary action against an approved person where there is evidence of personal culpability on the part of that approved person. Personal culpability arises where the behaviour was deliberate or where the approved person's standard of behaviour was below that which would be reasonable in all the circumstances at the time of the conduct concerned*" (DEPP 6.2.4G). Consistent with this, DEPP made clear that the FSA would not bring disciplinary proceedings against an approved person for misconduct merely because a regulatory failure had occurred in an area of the business for which that person was responsible (DEPP 6.2.7G). More was needed i.e. '*personal culpability*'.

27. The burden of proof in any disciplinary proceedings was on the FSA (DEPP 6.2.9), and the standard of proof was the civil standard i.e. on a balance of probabilities(15). It follows that, pursuant to the FSA's guidance, an approved person could only be '*guilty of misconduct*' if the FSA was able to establish, on a balance of probabilities, '*personal culpability*', as defined by DEPP, for (1) a breach of one of the '*Statements of Principle*' and/or (2) being '*knowingly concerned*' in a breach by the firm of a requirement imposed on the firm by or under the Act(16).

28. Section 66 of the Act imposed a time limit on the FSA for bringing disciplinary proceedings for '*misconduct*'. The position was that, until June 2010, the FSA was required to issue a Warning Notice (i.e. warning that the FSA proposed to take action) against an approved person within two years of the FSA becoming aware of the alleged misconduct (the FSA was aware of alleged misconduct if it had information from which the misconduct could reasonably be inferred); and,

(15) See Andrew Jeffery v FCA [2013] UKUT B4 (TCC) at paragraph [28]; and Mark Anthony Financial Management and others v FCA [2012] UKUT B17 (TCC) at paragraph [22].

(16) Part 3 ('*FSA Enforcement*') of the FSA's report entitled '*The failure of the Royal Bank of Scotland*' dealt with the legal test for bringing disciplinary proceedings, and stated (at paragraph 12) as follows (emphasis added): "*The legislative requirements include assessing the likelihood of Enforcement Division being able to establish conclusive evidence to prove any case. This is particularly relevant in cases against individuals, which require a high standard of evidence and very strong evidence of an individual's personal culpability.*" The correct test was that set out in paragraph 27 above.

from June 2010, the period was extended to three years. From July 2014, the period was further extended to six years.

29. The FSA's disciplinary sanctions (for '*misconduct*') were the ability (1) to impose a financial penalty, (2) to publish a statement of the individual's misconduct, (3) to suspend, for such period as the FSA considered appropriate, any approval of the performance by the individual of any function to which the approval related and (4) to impose, for such period as the FSA considered appropriate, such limitation or other restrictions in relation to the performance by the individual of any function to which any approval related[17].

30. The disciplinary proceedings brought against Mr Cummings alleged that he was personally culpable both for a breach of one of the '*Statements of Principle*' (Principle 6) and for being '*knowingly concerned*' in a breach by BoS of one of the '*Principles for Business*' (Principle 3) (paragraphs 35 to 37 below). The FSA fined Mr Cummings for his misconduct.

B.5 Prohibition proceedings: '*an individual is not a fit and proper person*'

31. Section 56 of the Act enabled the FSA to make a prohibition order if it appeared to the FSA that the individual was '*not a fit and proper person*' to perform functions in relation to a regulatory activity carried on by an authorised firm. The purpose of a prohibition order was, and is, protective, and not punitive i.e. such an order being made to protect other industry participants and customers, and to maintain and uphold the reputation of the financial services industry[18]. As with disciplinary proceedings for '*misconduct*', the burden of proof in any prohibition proceedings brought by the FSA on the basis that an individual was not '*fit and proper*' was on the FSA, and the standard of proof was the civil standard i.e. on a balance of probabilities[19]. It was widely accepted that establishing that a person was not '*fit and proper*' was more challenging than establishing '*misconduct*'[20].

32. If the FSA established that a person was not '*fit and proper*', it was able to make a range of prohibition orders, including prohibiting an individual from performing a specified function in relation to any class of regulated activity or even prohibiting an individual from being employed by a particular type of firm. An individual did not need to be an approved person for the FSA to bring action seeking a prohibition order. Such action could, therefore, have been brought by the FSA against SIFs even after they ceased to be approved persons.

33. There was, and is, no time limit imposed by the Act on the bringing of prohibition proceedings against individuals on the basis that they are not '*fit and proper*' (the rationale for this being that prohibition is a means of protecting the industry and the public from people who are not fit and proper). It follows that it remains open to the FCA to bring prohibition proceedings if it appears to the FCA that any individual involved in the failure of HBOS is not a '*fit and proper*' person. It is for this reason that the FCA is able to consider afresh whether other former senior managers of HBOS should now be investigated with a view to bringing prohibition proceedings, even though it is too late to bring disciplinary proceedings against them for misconduct (and thus to impose a fine).

34. The proceedings brought against Mr Cummings alleged that (in addition to being guilty of '*misconduct*') he was not '*fit and proper*', and that a prohibition order should be imposed. A partial prohibition was imposed on Mr Cummings.

(17) The sanctions identified at (3) and (4) were brought into force by the Financial Services Act 2010 with effect from 8 June 2010.
(18) See Chalinge & others v FSA [2012] UKUT B21 (TCC) at paragraph [104].
(19) See Ghanshyam Batra v FCA [2014] UKUT 214 (TCC) at paragraph [21].
(20) This was particularly the case when the allegation was that the individual was incompetent rather than lacked honesty and integrity i.e. in the latter situation, a prohibition was the obvious order.

B.6 Disciplinary proceedings: against an authorised firm

35. The FSA's general rule-making power arose under section 138 of the Act, and enabled it to make such rules as it considered necessary or expedient applying to authorised persons with respect to the carrying on by them of regulated activities. Acting under this power, the FSA made rules entitled '*Principles for Businesses*' which it described as being a general statement of the fundamental obligations of authorised firms under the regulatory system. There were eleven Principles. Principle 3 ('*Management and control*') provided that: "*A firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems.*"

36. Under sections 205 and 206 of the Act, if the FSA considered that an authorised person (i.e. a firm) had contravened a '*requirement*' imposed by or under the Act, it could publish a statement to that effect and/or impose a financial penalty. The burden of proof was on the FSA to establish (to the civil standard) that the firm had contravened a '*requirement*' (DEPP 6.2.15 G). The '*requirements*' imposed by or under the Act included the Principles for Businesses. The FSA would consider all the relevant circumstances of the case when deciding whether to impose a penalty or issue a public censure (DEPP 6.4.1 G). There was, and is, no time limit for bringing disciplinary proceedings against a firm under sections 205 and 206.

37. The disciplinary proceedings brought by the FSA against BoS alleged a breach of Principle 3, and the FSA sought to issue a public statement to that effect but did not seek to impose any financial penalty. This Principle was also relevant to the disciplinary proceedings brought by the FSA against Mr Cummings, as the FSA alleged that he was '*knowingly concerned*' in BoS's breach of Principle 3.

B.7 Powers to investigate under sections 167 & 168: the '*statutory threshold test*'

38. Under section 167 of the Act, the FSA had a general power to appoint investigators "*if it appears to the [FSA] that there is good reason for doing so*". The matters that could be covered by such an investigation included "*the nature, conduct or state of the business*" or "*a particular aspect of that business*":

    (a) The FSA's '*Enforcement Guide*' explained, at EG 3.8, the circumstances in which the FSA might commence a section 167 investigation[21]:

    "Where the FSA has decided that an investigation is appropriate (see chapter 2) and it appears to it that there are circumstances suggesting that contraventions or offences set out in section 168 may have happened, the FSA will normally appoint investigators pursuant to section 168. Where the circumstances do not suggest any specific breach or contravention covered by section 168, but, the FSA still has concerns about a firm, an appointed representative, a recognised investment exchange or an unauthorised incoming ECA provider, such that it considers there is good reason to conduct an investigation into the nature, conduct or state of the person's business or a particular aspect of that business, or into the ownership or control of an authorised person, the FSA may appoint investigators under section 167."

    (b) It follows that section 167 was a general investigatory power that the FSA could have used in relation to HBOS if, for example, it had considered in late 2008/early 2009 that it needed to investigate the bank for the purpose of enabling it to identify potential culpability in

(21) EG (which did not form part of the FSA Handbook) described the FSA's approach to exercising the main enforcement powers given to it under the Act.

relation to the failure. The FSA did not use the power under section 167 to investigate HBOS.

39. Section 168 of the Act contained a power enabling the FSA to appoint an investigator in relation to both individuals and authorised firms:

(a) As regards individuals, section 168 enabled the FSA to appoint an investigator if "*it appears*" to the FSA that "*there are circumstances suggesting that*" (1) "*an individual may not be a fit and proper person*" or (2) "*a person may be guilty of misconduct for the purposes of section 66*". This provision is referred to in this Report as 'the statutory threshold test' under section 168 for investigating individuals. It enabled the FSA to investigate the conduct of an approved person if it appeared to the FSA that there were circumstances suggesting that the approved person may not have been '*fit and proper*' and/or may have been '*guilty of misconduct*'. It set a relatively low threshold for commencing an investigation into the conduct of an approved person. This was the provision used by the FSA to investigate the conduct of Mr Cummings.

(b) As regards authorised firms, section 168 enabled the FSA to appoint an investigator if "*it appears*" to the FSA that "*there are circumstances suggesting that*" there may have been a contravention of a *"rule made by the Authority"*. This provision is referred to in this Report as 'the statutory threshold test' under section 168 for investigating a firm. Again, this set a relatively low threshold for conducting an investigation of a firm. This was the provision used by the FSA to investigate BoS.

40. The FSA's internal guidance set out who was responsible for making the decision in relation to exercising these statutory powers of investigation. A document entitled '*Project Management Module*' provided that it would be the Project Sponsor who would be *"responsible for exercising certain delegated FSA powers, e.g. the appointment of investigators under s167/168…"*. An accompanying '*Decisions Table*', annexed to the Project Management Module, explained that the initial Project Sponsor for any investigation would generally be the Head of Department who authorised the referral, unless the role had been otherwise delegated. The Project Sponsor would also be responsible for extending the scope of any investigation.

B.8 The pre-referral stage: case selection and the decision to investigate

41. In summary, the normal procedure by which a subject (whether a firm and/or an individual) would be referred to Enforcement for investigation would involve (1) the '*referring department*', such as the department responsible for supervising a particular firm or individual (referred to below as 'Supervision'), raising with Enforcement a potential matter for referral for investigation; (2) there would then be a dialogue between the referring department and Enforcement as to whether or not to refer the matter for investigation and the identity of the potential subject for referral (i.e. firm and/or individual); (3) a decision would then be made by the referring department and Enforcement; and (4) if the decision was to make a referral for investigation, the decision would be recorded in an Enforcement Referral Document ('ERD'). The ERD would be signed off by a manager from the referring department, the lead supervisor (if the referring department was not Supervision), the Enforcement Relationship Manager(22) and the particular Enforcement Head of Department who would then become the Project Sponsor(23). According to the ERD Guidance Notes, "*ERDs should be completed within two weeks of the decision to refer*" (i.e. the decision to refer was made prior to the ERD being signed off); and an ERD was intended to "*form a succinct record of the issues relevant to the referral, allowing the decision on referral to*

(22) The Enforcement Relationship Manager (who was part of Enforcement) would assist Supervision and Enforcement with the decision-making process as to which matters and subjects should be referred to Enforcement for investigation.
(23) A Head of Department was responsible for the executive management of a specific operational area. Within Enforcement, there were several Heads of Department.

be fully informed and also providing a clear record of the decision to refer…it should be a succinct summary of the key issues and clear explanation of why it has been agreed that it is appropriate for the matter to be referred."

42. Although this was the normal pre-referral process (leading up to the ERD being signed off), during the Review Period (i.e. October 2008 to September 2012) there was limited guidance relating to the identification and selection of cases for referral to Enforcement for investigation under sections 167 or 168. Some explanation as to how the FSA would approach the pre-referral decision-making process was provided by the following documents:

(a) The Enforcement Guide. At EG 2.10, this stated as follows (emphasis added):

"Before it proceeds with an investigation, the FSA will satisfy itself that there are grounds to investigate under the statutory provisions that give the FSA powers to appoint investigators. If the statutory test is met, it will decide whether to carry out an investigation after considering all the relevant circumstances. To assist its consideration of cases, the FSA has developed a set of assessment criteria. The current criteria (which are published on the Enforcement section of the FSA website) are framed as a set of questions. They take account of the FSA's Regulatory objectives, its strategic/supervision priorities… and other issues such as the response of the firm or individual to the issues being referred. Not all of the criteria will be relevant to every case and there may be other considerations which are not mentioned in the list but which are relevant to a particular case…".

(b) The Guidance Notes to the ERD (i.e. guidance for those completing the ERD). These made clear that, in deciding whether an issue should be referred for investigation, the FSA would need to ascertain that it was "*sustainable on legal grounds*" (i.e. whether the statutory threshold tests for investigating under sections 167 or 168 were met) and it was "*appropriate on policy grounds*". As regards the '*policy grounds*', this required Supervision and Enforcement to consider whether, "*should the concerns or suspicions be made out by the investigation*", enforcement action would be in line with the FSA's objectives and its strategic priorities; and, in considering this issue, they had to consider the '*Referral criteria*' set out in the Guidance Notes. These '*Referral criteria*' required the answering of questions including: "*Has there been actual or potential consumer loss/detriment?"; "Are there actions or potential breaches that could undermine public confidence in the orderliness of financial Markets?*"; and "*Are there issues that indicate a widespread problem or weakness at the firm/issues?*". The ERD Template (i.e. the standardised document which, once completed and signed, was the ERD) listed the '*Referral criteria*' questions, which then needed to be answered when completing the ERD.

(c) An internal FSA presentation document entitled '*MRGD and Enforcement: Collaborative Working*' dated 30 October 2008. This was produced by Mr Smith (an Associate in the Enforcement Referrals and Strategy Team, in Enforcement) and Mr Walker (Head of Department of 'Retail 1', in Enforcement) for a presentation by Enforcement to the FSA's Major Retail Group Division (i.e. the part of Supervision responsible for the supervision of HBOS). The document identified, among others, the following topics:

(i) '*Referral process: practicalities…*' which referred to "*Issues to be raised with Enforcement promptly after identification and assessment by firm supervisor*"; "*Enforcement to respond on issues promptly after issues raised*"; "*Once sufficient information is available, make a referral decision promptly*" and "*Decisions to be recorded in writing promptly*".

(ii) '*Issue identification & assessment*' which referred to "*Discussions with Enforcement triggered by: Material issue identified at a firm or in relation to a SIF or other individual at a firm*". As set out in section D below, the '*material issue*' which was identified by Supervision in relation to HBOS and then raised with Enforcement in around December

2008 was the failure of the bank. It was not the apparent misconduct of any particular individual.

(iii) '*What will Enforcement do pre-referral?'* which referred to *"Review primary material"*; "*Provide challenge based on forensic analysis of evidence and legal review*"; "*Clarify intended message which a public disciplinary outcome might deliver*" and "*Inform the decision as to what should be referred and how a referral should be formulated*".

(iv) '*Decision-making*' which stated, among other matters, "*Staff to summarise options and make recommendation – Assess merits and risks of each option*"; "*Supervision HoD [i.e. Head of Department] to make referral decision on behalf of Supervision*"; "*Enforcement Strategy Manager and/or HoD to make decision on behalf of Enforcement*"; and "*Effective operation of the Supervision/Enforcement interface to refer the right cases into Enforcement efficiently*". As set out in section D below, the only '*option'* considered by Supervision and Enforcement (prior to the ERD dated 26 February 2009 relating to Mr Cummings) was the referral of Mr Cummings.

43. It is apparent from the above that the FSA would not conduct an investigation merely because the statutory threshold test (whether under section 167 or 168) was met. Rather, the FSA, in deciding whether or not to conduct an investigation (once the statutory threshold test was met), would consider "*all the relevant circumstances*" (EG 2.10) by reference to '*assessment criteria'/'referral criteria*' which included consideration of the '*regulatory objectives*' and whether the issue being considered was relevant to the FSA's '*strategic priorities*'.

44. By late 2008, one of the FSA's '*strategic priorities*' was an increased focus on bringing enforcement action against SIFs. The FSA made a strategic decision to investigate more senior managers because it took the view that enforcement action against senior managers/SIFs had real impact in discouraging misconduct i.e. in order to achieve what the FSA frequently referred to as '*credible deterrence*', there was a general belief that senior managers must be held to account:

(a) The Guidance Notes to the ERD contained a section entitled '*Individual liability of Significant Influence Function holders*' which stated as follows (emphasis added):

"ExCo(24) has made the strategic decision to focus more of our resources on examining the behaviour of those that hold a Significant Function (SIF). There is an FSA-wide expectation that, where appropriate, we will take more enforcement action against senior management. We've made a strategic decision to investigate more individuals. So, even though that could mean that cases take longer and quick public outcomes are delayed, the FSA considers it to be a price worth paying to achieve credible deterrence.

Margaret Cole has publicly warned the industry that they "can expect to see more Supervision and Enforcement focus on individuals – especially SIF holders." She also commented that previously "for SIF holders, we've tended to focus on cases of dishonesty or lack of integrity where prohibition or withdrawal of approval was the most appropriate outcome. In the future, we will also consider the competence of SIF holders, and we won't shy away from pursuing cases against individual SIF holders who breach our Principles and Code. In these cases, fines may be more appropriate than prohibitions.

As part of this new focus it is important that the issue of whether SIF individuals should be investigated should be considered as part of the ERD. Where, due to lack of information, it is not possible to identify an individual for referral, the ERD should at least identify the SIF

(24) This was a reference to the FSA's Executive Committee.

individuals within the firm who are responsible for the area in which the potential breach has been identified."

(b) EG 2.31 & 2.32 (under the heading '*Senior management responsibility*') stated as follows (emphasis added):

"The FSA is committed to ensuring that senior managers of firms fulfil their responsibilities. The FSA expects senior management to take responsibility for ensuring firms identify risks, develop appropriate systems and controls to manage those risks, and ensure that the systems and controls are effective in practice. The FSA will not pursue senior managers where there is no personal culpability. However, where senior managers are themselves responsible for misconduct, the FSA will, where appropriate, bring cases against individuals as well as firms. The FSA believes that deterrence will most effectively be achieved by bringing home to such individuals the consequences of their actions. The FSA's policy on disciplinary action against senior management and against other approved persons under section 66 of the Act is set out in DEPP 6.2.4 G to DEPP 6.2.9 G…

The FSA recognises that cases against individuals are very different in their nature from cases against corporate entities and the FSA is mindful that an individual will generally face greater risks from enforcement action, in terms of financial implications, reputation and livelihood than would a corporate entity. As such, cases against individuals tend to be more strongly contested, and at many practical levels are harder to prove. They also take longer to resolve. However, taking action against individuals sends an important message about the FSA's regulatory objectives and priorities and the FSA considers that such cases have important deterrent values. The FSA is therefore committed to pursuing appropriate cases robustly, and will dedicate sufficient resources to them to achieve effective outcomes."

(c) DEPP 6.2.6(1)G highlighted the role of SIFs, and included the following statement (emphasis added):

"The FSA may take into account the responsibility of those exercising significant influence functions in the firm for the conduct of the firm. The more senior the approved person responsible for the misconduct, the more seriously the FSA is likely to view the misconduct, and therefore the more likely it is to take action against the approved person."

(d) Any assessment of the reasonableness of the scope of the FSA's investigations in relation to the failure of HBOS must be considered in the context of the FSA's strategic priority of bringing actions against SIFs.

45. The ERD Template (as amended with effect from December 2008) contained a section headed '*Probability of success and importance assessment*', and the ERD Guidance Notes read as follows: "*The referral should be assigned both a 'probability of success' and an 'importance' rating from the rating range Low, Medium Low, Medium High or High. The 'probability of success' refers to the likelihood of the case resulting in a public outcome. In many cases this is likely to be rated as 'medium low' or even 'low' at the referral stage, unless there are particular reasons to justify a higher rating. The 'importance' refers to the significance of the case measured against the strategic priorities of the referring department: it is a measure of the impact a public outcome would have.*" The prior ERD Template did not contain this section. One potential difficulty with assigning a '*probability of success*' at this stage was that, until such time as an investigation had been conducted, the FSA frequently would not be in a position to know whether it was likely to succeed in any subsequent disciplinary or prohibition proceedings.

46. Indeed, a point made by a number of Report interviewees was that, where the statutory threshold test for conducting an investigation was met and the FSA was deciding whether, in the light of "*all the relevant circumstances*", it was appropriate to conduct an investigation, an

important factor that was taken into account was the likelihood that, following an investigation, there would be successful disciplinary or prohibition proceedings i.e. a successful "*public outcome*". For example, Mr Jones (a Manager in Enforcement who led the Enforcement case team in the investigation of Mr Cummings), said: "*we satisfy ourselves that we have a reasonable prospect of succeeding and getting a good result from an investigation before we investigate*", and "*we take on cases that we think have a good chance of winning*". The impact of this approach is discussed in section D (paragraph 348) below.

B.9 Conducting the investigation

47. Once the ERD was signed, the investigation process could be started. Enforcement would put in place an investigation case team, some members of which would be appointed as investigators; and a Memorandum of Appointment of Investigators would generally be sent to the subject of the investigation, identifying the investigators and, in very broad terms, the nature of the investigation. The investigation would then begin, and would frequently start with a *'scoping'* meeting with the subject of the investigation in which the scope and nature of the investigation would be explained further. Thereafter, obtaining documents and conducting interviews were core features of the investigation process. Once the investigation had started, the Project Management Module (paragraph 40 above) required the Project Sponsor to conduct a review of the progress and scope of the investigation at thirty and sixty days, and at six months.

48. At the end of an investigation, the Enforcement investigation case team would produce an investigation report. Initially, the FSA would produce a Preliminary Investigation Report ('PIR') setting out a detailed summary and analysis of the evidence, and containing an assessment as to whether the facts showed breaches of statutory or regulatory provisions.

49. The PIR, if further enforcement action was intended, would generally be subject to a legal review by a lawyer (normally within the FSA) who was not part of the Enforcement investigation case team. This was intended to ensure that the case was reviewed by someone detached from the investigation. The review was intended to be a rigorous analysis of whether the evidence gathered by the investigation case team and presented in the PIR supported the alleged rule breaches or other misconduct.

50. Once the legal review had been conducted, the PIR together with a Preliminary Findings Letter would (in all but exceptional circumstances) be sent to the subject of the investigation inviting comments on Enforcement's provisional findings. If the subject provided responsive comments, the Enforcement case team would then generally issue an Investigation Report taking account of those comments.

51. Enforcement would then decide whether it considered that disciplinary and/or prohibition proceedings should be brought against the subject. The decision would generally be made by the Project Sponsor together with the legal reviewer; and the formal decision would be recorded in an Enforcement Submissions Document, which would be signed by the Project Sponsor and legal reviewer. If the Enforcement decision was that proceedings should be brought against the subject, the matter would be referred by Enforcement to the body within the FSA responsible for making the decision as to whether to bring such action. This decision-maker would generally be the RDC. The Enforcement investigation case team would submit to the RDC the following: the Investigation Report (or the PIR if no Investigation Report had been produced), a draft Warning Notice (stating the action the FSA proposed to take) and an Enforcement Submissions Document which would set out Enforcement's main submissions in relation to the alleged breach of regulatory requirements.

B.10 The RDC

52. Under section 395 of the Act, the FSA was required to have a procedure whereby the decision-maker in relation to the giving of Warning and Decision Notices was not directly involved in establishing the evidence on which the decision was based i.e. was independent of Enforcement. The FSA's procedure was that such decisions were made by the RDC, which was separate from the FSA's executive management structure, with its own legal advisers and support staff(25).

53. The RDC's decision-making process required that, if Enforcement considered that action requiring a Warning Notice was appropriate, it would submit papers to the RDC with a recommendation that a Warning Notice be issued (paragraph 51 above). If the RDC decided it was appropriate, it would send out a Warning Notice informing the firm or individual of the action the FSA proposed to take and why. The firm or individual would then be given an opportunity to make written representations to the RDC (to which Enforcement was able to reply) and to make oral representations at a hearing.

54. The RDC would then make a decision and, if appropriate, issue a Decision Notice (stating the decision taken by the FSA). In the context of contested disciplinary or prohibition proceedings, the RDC would decide the appropriate penalty (if any) and whether or not it would be appropriate (for example) to impose a prohibition order. The subject of a Decision Notice had the right of a full merits appeal to the Upper Tribunal.

B.11 Settlement of enforcement actions

55. Parties to enforcement action could seek to resolve the matter through settlement discussions. The FSA had a policy whereby a person/firm subject to enforcement action could agree to a financial penalty or other outcome (such as a prohibition) rather than contest the action. Decisions on settlements would be taken by two senior managers within the FSA staff (known as *'settlement decision makers'*) rather than by the RDC. Settlement discussions could take place at any time during the enforcement process. The FSA's guidance was that *"settlement after a decision notice will be rare"* (DEPP 5.1.3G).

B.12 Final notices

56. The FSA would issue a Final Notice when the action identified in the Decision Notice took effect (either because there was no referral to the Upper Tribunal or because the Upper Tribunal reached a decision and any appeals had been determined).

(25) The requirement for separation between the Enforcement investigation case team and the decision-maker was altered by the Financial Services Act 2012.

C. The Relevant Factual Background

57. This section sets out the relevant factual background for the purpose of assessing the reasonableness of the scope of the FSA's enforcement investigations. In producing this section, much assistance has been obtained from the former FSA employees who were interviewed for the purpose of this Report (i.e. Report interviewees)(26).

C.1 The pre-referral period: 1 October 2008 to 26 February 2009

58. On 1 October 2008, HBOS sought Emergency Liquidity Assistance from the Bank of England. Under the Terms of Reference for this Report (annexe 2), this has been treated as the date of failure of HBOS. At the time, it was also viewed within the FSA as the date when the bank failed: Sir Hector Sants (CEO of the FSA, and a member of the FSA's Board and Executive Committee, 'ExCo') said in his Report interview: "*…from a supervisory perspective, a bank fails at the point it needs emergency public assistance*"; and an internal FSA document produced in June 2012 (entitled '*Draft Note of Hector Sants' Views Re HBOS Failure*') stated that "*Emergency Liquidity Assistance (ELA) was first provided to HBOS on 1 October 2008. This is the point at which we consider HBOS 'failed'.*"

59. In the weeks immediately following the failure of HBOS, the FSA was understandably focussed on stabilising the bank (and indeed other banks) and it appears that possible enforcement action arising out of the failure was not the focus of attention. In her Report interview, Ms Williams (Manager, in Supervision, responsible for dealing with HBOS) said: "*Just to give you a bit of context, although Lloyds made the offer I think at the end of September, HBOS was really starved of funds. Lloyds wasn't funding it. The Bank of England was drip-feeding funding to it. So we were still facing a day-to-day sort of survival game, and we were also in parallel running some contingency planning just in case the Lloyds bid didn't go through…So there was a lot going on, and Enforcement was one thing amongst many, but actually stabilising and getting funding into HBOS was the number one priority because they were losing huge deposits at a huge pace even after the Lloyds bid was made.*"

60. Ms Williams' recollection of the first time enforcement action was discussed was when Mr Johnson (Head of Department of Major Retail Groups Division, in Supervision) "*said something along the lines of "when all of this is over we need to think about enforcement action and who we should take to enforcement.""* She explained that "*when all of this is over*" meant "*when the bank was stable*"; and that "*What was clear was that we didn't want to start enforcement action whilst the firm was at risk of collapsing…So it was sort of, in my mind, a clear understanding that we had to wait until the crisis, immediate crisis, had sort of ridden the storm…*". Ms Williams did not identify when this conversation occurred. Mr Johnson, in his Report interview, could not recall the timing of discussions concerning possible enforcement action, or the details of any such discussions.

61. The first document that reflects any consideration within the FSA of possible enforcement action in relation to the failure of HBOS is an email dated 3 December 2008 from Jon Pain (Director of Retail Markets, in Supervision, and a member of ExCo) to Clive Adamson (Director of Major Retail Groups Division, in Supervision), copied to Margaret Cole (Director of Enforcement, and a

(26) In this section, the roles of the various people identified were the roles that they held at the FSA at the relevant time.

member of ExCo). The email ('*Subject: Review of possible action*') stated: "*We talked a short while ago about you reviewing with Margaret's team the issue of potential enforcement action against senior management in RBS and HBOS. The way forward was to have a high level review quickly with Margaret's team on the realities of this potential. You might already have this in train but as we have a commitment to close this off with ExCo I do not want us not to do so in a timely fashion.*"

62. Sir Hector Sants made clear in his Report interview that, from the outset of the FSA's consideration of enforcement action, he set a very clear "*tone*". He said (emphasis added): "*Throughout this process from the outset that senior management of the FSA as a whole, executive committee as a whole, and I in particular made it very clear that we expected, as is the statutory duty of the FSA, that any enforcement action that could be taken here should be taken. So, I'm very – I'm very clear that the tone we set was, or the tone I set was, if there are – if it is appropriate to take enforcement action in the circumstances here, we would certainly expect enforcement action to be taken, and that covered all executives, past and present, of HBOS and the corporate entity. I'm confident that, from the beginning, as Jon Pain's emails there suggest, the tone being set was that, and the decision then how to proceed sits with Enforcement*". He also said: "*…it was very important, if there were cases to be taken, they should be taken because Parliament and the public rightly would expect the FSA to do it*", and that this applied both to commencing investigations and disciplinary proceedings. In their Report interviews, Ms Cole, Mr Walker (Head of Department of Retail 1, in Enforcement) and Mr Jones (Manager in Enforcement who subsequently led the Enforcement investigation case team in the investigation of Mr Cummings) all accepted that this was the tone and/or message from the FSA's senior management.

63. The trigger for consideration by the FSA of possible enforcement action was, as Mr Pain's reference to "*…potential enforcement action against senior management in RBS and HBOS*" suggests, the failure of those banks. This was accepted in their Report interviews by Sir Hector Sants, Ms Cole, Mr Pain, Mr Adamson, Mr Walker, Mr Johnson, Mr Hall, Tracey McDermott (who took over from Ms Cole as Director of Enforcement) and Mr Jones (although he and Ms McDermott were not involved in the decision-making at this time). As Mr Adamson put it, when asked to identify what had prompted consideration of enforcement action: "*The failure of HBOS was the trigger for thinking about it.*"

64. The response from Mr Adamson (Supervision) to the email from Mr Pain (Supervision) was: "*[Mr Hall] has already talked to [Mr Walker] on RBS where we will shortly see report commissioned by new management. We are setting up session with [Mr Walker] to discuss where we are with this and HBOS.*" It is apparent from this email exchange that, by 3 December, there had been some discussions between senior managers of both Supervision and Enforcement in relation to possible enforcement action in respect of both HBOS and RBS; and that ExCo was being kept informed of these discussions. None of the Report interviewees recalled the details of such discussions, and there were no attendance notes, emails or other documentary records of any such discussions. The fact that ExCo was being kept informed reflected the importance attached to this within the FSA.

65. By an email dated 5 December 2008, Mr Johnson (Supervision) wrote to Ms Williams (Supervision), copied to Mr Adamson (Supervision) and Mr Walker (Enforcement), on the subject 'HBOS', stating: "[*Mr Walker], Clive and I spoke about the possibility of taking Enforcement action against HBOS, amongst others. Following our discussions I outlined a possible case around corporate – lack of adequate credit systems and procedures, lack of oversight and inadequate challenge from group. To help think through this [Mr Walker's] team have offered to look through some of the background. As a starter for 10 could you send him a copy of the Arrow review on corporate with its long RMP. This does not preclude any other ideas you may have.*" It, therefore, appears that it was probably Mr Johnson (i.e. Head of Department of Major Retail Groups Division, in Supervision) who first identified the Corporate Division within HBOS as the focus for potential enforcement action. In his Report interview, Mr Johnson said that the reason why the

Corporate Division would have been identified as the focus of attention was that the FSA already had "*…a richness of information…that would allow us to progress an initial case, an Enforcement case, more speedily with Peter Cummings*". This same factor was also referred to in their Report interviews by Ms Williams (Supervision) and Ms Thomas (Manager in Supervision, responsible for dealing with Lloyds Banking Group).

66. By an email dated 6 December 2008, Mr Walker (Enforcement) wrote to Mr Taylor (Enforcement Relationship Manager), forwarding Mr Johnson's email of 5 December, saying (emphasis added): "*As you will see from this we have a potential referral of HBOS and certain senior managers. We also discussed RBS and Bradford and Bingley. Both appear to be potential significant referrals, possibly focussing on individuals. Let's catch up on Monday.*" None of the Report interviewees who were asked about this, and other similar references, could remember which if any specific "*senior managers*" within HBOS were being considered for referral other than Mr Cummings. Insofar as the interviewees had any recollection, it was that there had been no systematic consideration of any other individuals at this time. Mr Adamson said: "*There was certainly at that point no real discussion of anybody above Cummings.*"

67. An email also dated 6 December 2008 from Mr Walker (Enforcement) to Ms Cole (Enforcement), '*Subject: Possible referrals: HBOS, RBS, B and B*', stated: "*I met Clive Adamson, [Mr Hall], [Mr Johnson] and [a junior employee within Enforcement] yesterday. The outcome of this is that there are potential referrals of HBOS, RBS and Bradford and Bingley and senior managers at each firm. The referrals relate to failures in various areas that contributed to the firms' deteriorating financial positions. You and I are due to meet on Monday when I will update you in more detail.*" On 8 December, Ms Cole responded "*ok*". In their Report interviews, neither Mr Walker nor Ms Cole could recall which, if any, HBOS *"senior managers"* other than Mr Cummings had been under consideration at this time.

68. On 12 December 2008, HBOS issued a Trading Update. This reported estimated impairment losses in the Corporate Division of £3.3 Billion, and estimated losses (including due to Market dislocation) in the Treasury Division of £2.2 Billion. Those in Supervision responsible for dealing with HBOS would obviously have been well aware of these figures. They clearly reflected a significant problem within HBOS outside the Corporate Division.

69. On 15 December 2008, Mr Davies (Senior Associate in Supervision, working on the '*SIF Project*'(27)) sent an email to Ms Williams (Supervision) attaching a newspaper article from The Times, relating to Mr Cummings, with the headline "*Get rid of this man who broke the bank*". Mr Davies asked whether "*the FSA should be considering taking enforcement action against this individual on the grounds of competence*". On 17 December, Ms Williams sent a responsive email to Mr Davies and Mr Smith (Associate in the Enforcement Referrals and Strategy Team, in Enforcement): "*Both of you have contacted me on this issue and we have already sent details to Enforcement regarding the lengthy RMP programme that we put in place with the Corporate Division this summer…There are certainly a case we should consider [sic] but it would make sense to do so in a co-ordinated way.*" Mr Smith responded the same day: "*…I should add that I do have copies of the RMP and the 17 October letter to Peter Cummings.*" This was the first express reference to Mr Cummings in the FSA's email exchanges relating to possible enforcement action, although it appears (from this email and from various Report interviewees) that he may already have been the subject of discussion.

70. Also on 17 December 2008, an internal Supervision email ('*Subject: HBOS – Corporate impairment charge*') recorded that the Corporate book "*continues to show signs of rapid deterioration*", that "*current estimates are for somewhere in the range £4.5bn – £6bn*", and that,

(27) The SIF Project started in around August 2008, and was in part a response to the Treasury Select Committee report earlier in the year in which the FSA was asked to review its approach to the scrutiny and supervision of firms' senior management. By an email dated 18 December 2008 from Mr Davies to Ms Williams (among others), Mr Davies stated that "*the role of the SIF project team is to implement ExCo's steer on holding SIFs to account…*".

even taking account of a margin of error, "*they are up considerably on the numbers released by the firm on Friday*" (i.e. in the Trading Update of 12 December).

71. On 18 December 2008, Mr Smith (Enforcement) sent an email to Mr Davies (Supervision) and Ms Williams (Supervision) (emphasis added): "*I found the meeting this morning to be useful and promised to circulate the Enforcement Referral Document (ERD) template to MRGD to begin setting out the fundamental concerns and why this matter should be referred to Enforcement. I think the initial analysis of how APER applies to the issues that have been identified is incredibly helpful and we'll now need to focus on how the actions/omissions of individuals maps across to the relevant sections of APER and, in turn, the headline issues in HBOS' Corporate Division, so that we can begin to see, factually, what a case against the relevant SIF holders at HBOS would look like. I think it would also be useful if we could see something from the Banking Sector team as to how the firm's strategy and actions compares to those of its peers…*". He raised the issue as to "*how we should communicate to the relevant individuals (and the firm) that Enforcement is currently being considered.*"

72. On 22 December 2008, Ms Williams (Supervision) sent an email to Mr Smith (Enforcement) and Mr Davies (Supervision) copied, among others, to Mr Johnson (Supervision), in which she said (emphasis added): "*We need to give very careful thought as to which individuals we consider for enforcement or whether it is the firm itself. There are specific issues relating to the management of Corporate that we have discussed with you but there are other equally significant issues, such as the funding gap and the large portfolio of structured credit that have contributed to HBOS's problems (and possibly we could add the heavy weight of specialised mortgages but this has yet to play out). Is it appropriate to focus on only one strand of the contributing factors? I'd like to get [Mr Johnson's] thoughts on these points before we go any further*". Ms Williams accordingly raised, clearly, the question as to whether it was appropriate to focus enforcement action solely on the Corporate Division given the "*other equally significant issues*" within the failed bank. When asked about this email in her Report interview, Ms Williams commented: "*I'm saying it was – it's not just Corporate where they have some serious failings. At that point clearly I didn't appreciate International.*"

73. There is no documentary record of Mr Johnson's "*thoughts on these points*". In his Report interview, Mr Johnson did not recall receiving this email or his response to it. He acknowledged that he would have expected these "*other equally significant issues*" to have been investigated at some point in time, but stated that he considered Mr Cummings to be an appropriate place to start the investigation "*…because that's where we have a richness of evidence directly in front of us*". Mr Johnson fairly acknowledged that he lacked any actual recollection, but said: "*…as part of the initial discussions around what the scope of Enforcement actions could be, one of the things that we would naturally refer to would be where we had most evidence and most knowledge at an early stage. And that would be one where we would've had most knowledge around corporate and Peter Cummings, given the work that we'd done during 2008*". This was a reference to the work done by Supervision earlier in 2008.

74. Mr Davies (Supervision) replied to Ms Williams' (Supervision) email on 22 December 2008, stating (emphasis added): "*…I had a useful catch up with Clive Adamson…He confirmed that work was underway on HBOS, RBS and B&B into whether there might be grounds for enforcement against SIF individuals…He agreed that I might have meetings with those supervising RBS and B&B to review progress. He suggested that we look again in January to review progress and agree what might be reported to ExCo, who will consider the SIF project on 16 Feb…I also agree that we need to be fair and consistent in who we target, although I don't think this means that we must go for the firm instead of named SIF individuals. If as you imply there were different problems with different SIF individuals responsible, this suggests to me that we should take action against more than one individual and not target one scapegoat…*". It, therefore, appears that the focus was on SIFs, and that Mr Davies was alive to Ms Williams' concerns about not focussing on one issue and individual ("*one scapegoat*", to use his words) to the exclusion of others.

75. On 24 December 2008, Ms Williams (Supervision) sent an email to an Associate within Supervision asking her to "*set up a meeting early in the new year for the four of us (as above) to discuss the potential scope of enforcement action against HBOS*". The proposed attendees were to be Ms Williams (Supervision), Mr Johnson (Supervision), Mr Smith (Enforcement) and Mr Walker (Enforcement). The meeting was originally arranged to take place on 8 January 2009; but, due to a clash in Mr Johnson's diary, on 7 January it was rescheduled for 9 January. In an email to Ms Williams on 7 January, Mr Smith made the point (emphasis added): "*…given your view that it would be useful to have [Mr Johnson's] thoughts on the scope of this potential referral, in particular whether it should extend beyond the concerns about HBOS's Corporate Division, we agreed to move the meeting to 11 o'clock on Friday*" i.e. 9 January.

76. On 9 January 2009, the meeting took place. It was attended by Ms Williams (Supervision), Mr Johnson (Supervision), Mr Smith (Enforcement) and Mr Walker (Enforcement). There appears to be no attendance note of the meeting, or any other clear record of the matters discussed; and none of the people who attended that meeting could remember anything about it in their Report interviews(28).

77. The meeting appears, however, to have been important: later documents suggest that a decision was taken, during the meeting, to focus on Mr Cummings. On 12 January 2009, there were email communications recording the fact that Ms Williams (Supervision) was going to provide Mr Smith (Enforcement) with documents relating to the Corporate Division (i.e. to enable Mr Smith to assist in formulating a case for referral to Enforcement for enforcement action); and on 15 January 2009, there was an email from Mr Smith to Ms Williams, in which he said (emphasis added): "*These may be a bit too old as I thought our focus was on Cummings' involvement in expanding HBOS's corporate book since he started his role as CEO of the Division in 2006*".

78. It therefore appears that, at the meeting on 9 January 2009 (the purpose of which was "*…to discuss the potential scope of enforcement action against HBOS"*), a decision was taken to focus enforcement action on Mr Cummings' involvement in expanding HBOS's Corporate business from the time when he started his role as CEO of the Division in 2006.

79. However, there is no apparent record of how that decision was made; of the person(s) who took that decision; of the reasons for that decision; or of any consideration of the "*other equally significant issues*" at HBOS, and why they were not, at that point, going to be within the scope of the intended enforcement action.

80. On 19 January 2009, Mr Smith (Enforcement) sent an email to another Associate Enforcement Relationship Manager, in Enforcement, who had been given the task of reviewing the material provided by Supervision and producing a report for the purpose of considering an enforcement case against Mr Cummings. The email read: "*I think the key thing that [Mr Walker] wants is for us to be able to form a view on whether there are grounds to have an early fact-finding interview with Cummings. We can then use that to explore the key concerns and decide whether he should be subject to formal investigation*". The Associate's response that day was: "*My initial thoughts are that there are certainly grounds for an early fact-finding interview with Cummings.*" On the same day, Mr Smith sent an email to Ms Williams which stated: "*Given the direction which we're heading though, it might be worth making a start on an ERD*" i.e. an Enforcement Referral Document. As stated above (paragraph 41), the ERD was the document which recorded the decision to refer a subject to Enforcement, and provided a summary of the key issues and the

(28) Following his Report interview, Mr Smith produced some contemporaneous notes headed 'HBOS 9/1' i.e. which may be a reference to the meeting on 9 January 2009 (although it does not refer to an actual meeting, and the attendees of any meeting are not identified). Assuming the notes refer to the meeting, they do not assist in understanding what happened on 9 January and any decision-making process that took place at the meeting (although they do state: "*Before referral – interview Cummings*"). Following her Report interview, Ms Williams produced some contemporaneous notes which referred to a conversation with Mr Walker which she thought was made "*on or about 9 January*". The note does not assist in understanding what happened on 9 January, if it even relates to the meeting. It reads: "*[Mr Walker] Scope Bones [sic] of Enforcement 2005/6 review of corporate exposures vs RBS >PRD*".

factual basis for the referral. There was a standardised ERD Template (paragraph 42b above) which required those producing the ERD to consider (among other matters) the '*referral criteria*', which were set out as a series of questions in the Template.

81. On 20 January 2009, Ms Williams (Supervision) sent her first draft ERD to others (including Mr Johnson) within Supervision. It summarised the potential breaches by Mr Cummings of Statements of Principle 5, 6 and 7 (paragraph 23 above). In answer to the ('*referral criteria*') question in the ERD Template, "*Are there issues that indicate a widespread problem or weaknesses at the firm?*", the response was: "*Yes. There are widespread systems and control weaknesses within the Corporate division which are detailed in the RMP programme issued to the firm on 17th October 2008. The extensive nature of these weaknesses would indicate that the Group Risk and Group Audit functions were not providing effective second and third lines of defence.*" Group Risk and Group Audit (being part of the second and third lines of defence adopted by HBOS in its approach to risk management) were not areas for which Mr Cummings was responsible.

82. On 23 January 2009, Ms Williams (Supervision) forwarded to Mr Smith (Enforcement) a slightly amended draft ERD, which he then forwarded to Mr Jones (Enforcement). In response, Mr Jones sent an email to Mr Smith and to an Associate in Enforcement in which he asked the Associate (emphasis added): "*…do you have any background papers you think I should see? I'm thinking particularly supervision papers where they raised (or failed to raise) concerns, and any that go to why others (eg the CEO?) should not be put under investigation*". In his Report interview, Mr Jones did not recall how much information had been provided to him by this time about the possible enforcement action. He was clear, however, that by the time he came to be involved in late January 2009, a decision had been taken to focus on Mr Cummings.

83. It is noteworthy that Mr Jones's immediate response, upon learning of that decision, was to raise the issue as to why others, including the former CEO of the failed bank (Mr Hornby), were not being put under investigation. As he put it in his Report interview: *"…in this sort of failure I think you always look to that as a natural instinct to – you want to get the person who's ultimately responsible, the most senior person, that's going to get you the biggest impact in the press and give the best impact in the regulated community"*. Mr Jones, in his Report interview, made the point that a view had already been formed, by early 2009, that Mr Hornby would not be allowed back into the industry: *"It seemed highly unlikely to us that having ruined one bank, or in charge of a bank which had collapsed, that he would have been approved to do the same thing, to take the same role again."*

84. On 29 January 2009, Mr Smith (Enforcement) sent a "*revised version of the ERD for Cummings*" to Mr Jones (Enforcement) making the point that the previous version (produced by Supervision) "*didn't make a great deal of sense to me initially so I've changed it rather a lot*". He then said (emphasis added): "*The one thing that concerns me slightly about this is that we may need to expand on precisely how/why Cummings is personally culpable for HBOS's Corporate division failings and also why the failings don't extend up into the Group Board.*" The revised draft ERD contained a question which Mr Smith had inserted, in response to paragraph 2.4 of the ERD Template, "*Other relevant factors*" (emphasis added): "*Is there anything else to add which might be relevant to the decision whether to refer. Any thoughts on other individuals in the Corporate division? HBOS Group?*". Mr Jones's response, by email that day, included the comment and question (emphasis added): "*I agree with [Mr Smith] – why not others on the board?*" In his Report interview, Mr Jones explained that this response arose from the fact that he was "*…instinctively concerned that in all of the three big – these three big investigations that we were starting that we weren't investigating any of the chief executives*". His reference to the '*three big investigations*' were those into HBOS, RBS and Bradford & Bingley ('B&B').

85. On 30 January 2009, Mr Smith (Enforcement) sent a further draft revised ERD to Mr Jones (Enforcement). His covering email said: "*I think the main thing is to put the onus back on*

Supervision to provide clarification in those areas we discussed". Mr Smith's revised draft ERD made some further important changes:

(a) Mr Smith added a sentence in response to the following ERD Template '*referral criteria*' question: "*Are there issues that indicate a widespread problem or weaknesses at the firm?*" (i.e. the response which addressed Group Risk and Group Audit). He requested as follows (emphasis added): "*Please explain whether we consider these to be failings at Group level of HBOS or if this is something which Cummings had responsibility for.*"

(b) Mr Smith also changed the question under paragraph 2.4 of the ERD Template to read (emphasis added): "*Please explain to what extend [sic] the concerns extend beyond Cummings to Group and why no other individuals should be referred.*"

A copy of this revised draft ERD is attached at annexe 3.

86. In the revised draft ERD, Mr Smith was therefore clearly raising the question, already raised previously by Ms Williams and Mr Jones, as to why Mr Cummings was the sole focus of enforcement action. As Mr Smith put it in his Report interview: *"…it didn't make a great deal of sense to me. I thought there wasn't enough sort of clarity on what the focus of the investigation should be"*, and for that reason he was *"…trying to get Supervision to provide a bit more clarity around that, whether there were other individuals or if it was really Cummings."*

87. Between 30 January and 5 February, it appears that some further changes were made to the draft ERD, and it was sent back to Ms Williams (Supervision) on 5 February. The covering email stated (emphasis added): "*We've now discussed it [i.e. within Enforcement] and I've been through the draft and made a number of changes. I'm afraid there are a number of points on which we would like some clarification, if at all possible…The key thing that we need to see in the ERD is an explanation of how Cummings was personally responsible for the issues that arose. In order to satisfy the statutory test under s.168 for putting Cummings under investigation, we need to be clear of the circumstances suggesting that, as an individual, he may have fallen short of the standards we expect…"*. The attached draft contained the same comment: "*Please explain whether we consider these to be failings at Group level of HBOS or if this is something which Cummings had responsibility for*"; and the same request under paragraph 2.4: "*Please explain to what extend [sic] the concerns extend beyond Cummings to Group and why no other individuals should be referred.*"

88. On 5 February 2009, Ms Williams (Supervision) sent an email to Mr Johnson (Supervision), forwarding him the latest draft ERD just received from Mr Smith, stating: "*Fyi – grayeful [sic] for your thoughts as to how we can pin the referral more directly on PC. He was responsible for setting the strategy of the division so had responsibility for ensuring the sys controls were commensurate with the risk they were writing. I think he had sign off for the larger deals, many of which failed, so closely involved in agreeing the risk*". There is no recorded response from Mr Johnson who, in his Report interview, did not recall addressing the matters raised by Mr Smith in the body of the draft ERD.

89. On Tuesday 11 February 2009, Ms Williams (Supervision) sent an email to Mr Smith (Enforcement) attaching "*a revised draft taking on board the points we discussed on Monday*". There is no record of what had been discussed on Monday. The revised draft ERD retained the two key sentences: "*Please explain whether we consider these to be failings at Group level of HBOS or if this is something which Cummings had responsibility for" and "Please explain to what extend [sic] the concerns extend beyond Cummings to Group and why no other individuals should be referred*". It, therefore, appears that Supervision had provided no response to Enforcement. In her Report interview, Ms Williams fairly observed that since she had already expressed the view that it was inappropriate to focus on Mr Cummings alone, she had been ill-placed to provide any response to the points raised by Enforcement. Thus, although she did not have any

specific recollection of why these points had not been answered, she did say: *"I think we hadn't resolved the only problems, and therefore we couldn't – I couldn't answer that question."*

90. On 12 February 2009, Ms Thomas (Supervision) sent an email to (among others, but no-one in Enforcement) Lord Turner (Chairman), Sir Hector Sants (CEO), Mr Adamson (Supervision), Mr Hall (Supervision) and Mr Johnson (Supervision). The email referred to an anticipated "*rns statement*" to be issued by Lloyds Banking Group, and referred to the fact that the HBOS financial figures "*will be materially worse. This is a combination of greater Marks on treasury assets and corporate impairments. Eg whilst the 12 dec hbos trading statement disclosed corporate impairments of 3.3bn for the first 11 months, the full year is now 6.6bn. Analysts inferred an annual loss of 6bn, this will actually be 11bn*". It does not appear that the information contained in this email (particularly in relation to the deteriorating "*Marks on treasury assets*") was raised with those people in Enforcement considering the scope of the proposed enforcement action.

91. On 12 February 2009, Ms Williams (Supervision) sent an email to Mr Smith (Enforcement) and Mr Johnson (Supervision), '*Subject "HBOS referral*'. She said: "*Just to be aware, Clive Adamson, [Mr Johnson] and I discussed the referral and possible risks to the FSA of a challenge. Clive suggested that given the high profile nature of the case, that this (and possibly other SIF referrals) should go trough [sic] ExCo so that there is full visibility."* The suggestion (coming from Supervision) that ExCo be asked to approve enforcement action was a highly unusual one (this normally being a matter for decision by Supervision and Enforcement); and the Report interviewees accepted that this reflected the public importance of the matter. As Mr Adamson put it: *"…this was a significant issue of reputation to the organisation and normally we elevate those to ExCo"*. The issue was raised by Mr Walker (Enforcement) with Ms Cole (Enforcement, and herself a member of ExCo); and, on 13 February, she sent an email to Mr Walker saying: "*There is no need to involve ExCo. I have already told Hector that Cummings is being referred and there is no need to depart from the normal process. I am sure Hector and ExCo would find it strange if they did. Can they get on with it please.*" Mr Walker replied the same day: "*Will do. We have an ERD ready to sign off*".

92. On 13 February 2009, Mr Hall (Supervision) sent an email to (among others) Sir Hector Sants (CEO), Mr Pain (Supervision) and Mr Adamson (Supervision), referring to a meeting that he and Ms Thomas (Supervision) had attended that day with the Finance Director of Lloyds Banking Group. As a number of the Report interviewees accepted, the email reflected a view that the problems within HBOS extended beyond the Corporate Division. Mr Adamson accepted, for instance, that it appeared to raise concerns "*about how the firm was run as a whole*". Ms Cole, however, (who had been forwarded the email by Sir Hector Sants) said in her Report interview that it was "*a form of verification – or at least a consistent view that Cummings and his division were a major cause of the HBOS issue*". The email '*Subject*' was *'Lloyds – HBOS losses*', and included reference to the Finance Director making the following points[29]:

"*Lloyds have been dismayed by the 'woeful' state of controls within HBOS and the lack of detailed MI available to them and the length of time it takes to make changes to what is produced.*

The culture within HBOS is one which seeks the lowest common denominator and works to that level. It was a culture which sought to get away with the lowest possible provisioning levels and had to be 'dragged kicking and screaming by their auditors' to a more prudent level particularly on the corporate side.

Lloyds had also been struck by the way in which HBOS had been run as a series of 'fiefdoms'. Ellis and Hornby had been all over Retail because that was their background and that was what they understood. Cummings on the other hand appeared to have been given a free reign – neither

(29) The email was produced by Mr Hall for internal FSA use, and reflected his understanding of what he had been told by the Finance Director of Lloyds Banking Group.

risk nor finance had had a very high profile within the BU; both were under-resourced and under-appreciated. It was little surprise that the controls were flaky – as evidenced by, say, a lack of covenant monitoring and the registration of collateral. The first of these points had been raised by the auditors in their management letter. Important as these points undoubtedly are, they are, however, second and third order to the fact that the wrong lending decision were taken (in particular the multiple layers of concentration to single counterparties (taking equity, mezz and financing deals) and the over-concentration within particular Markets…".

93. The content of this email does not appear to have been discussed with those people in Enforcement considering the scope of the proposed enforcement action (although it had been forwarded to Ms Cole). In their Report interviews, Sir Hector Sants, Ms Williams, Mr Adamson and Ms Thomas all agreed that it was clear by this time that serious failures appeared to have occurred outside the Corporate Division.

94. On 13 February 2009, Mr Smith (Enforcement) forwarded the latest draft ERD to various people within Supervision and Enforcement. The email contained the comment that "*…the ERD is absolutely fine as it stands (with the exception of some clarification around dates…)*". Significantly, this latest version of the draft ERD had deleted the two key sentences that had appeared in the previous several drafts i.e. "*Please explain whether we consider these to be failings at Group level of HBOS or if this is something which Cummings had responsibility for"* and "*Please explain to what extend [sic] the concerns extend beyond Cummings to Group and why no other individuals should be referred.*"

95. There is no documentary record of the matters raised in these two sentences ever having been discussed or resolved (either within Supervision or within Enforcement, or between those departments) prior to their deletion from this version of the draft ERD; and none of the Report interviewees was able to recall any such discussion or resolution having taken place, or to provide any explanation as to how these deletions came to be made. In his Report interview, Mr Smith could not remember why he had deleted these sentences.

96. Between 24 and 26 February 2009, the ERD was signed by Ms Williams (Supervision, the referring department), Mr Hall (Head of Department in Supervision), Mr Taylor (Enforcement Relationship Manager) and Mr Walker (Head of Department in Enforcement, and the Project Sponsor), thereby referring Mr Cummings to Enforcement for investigation. A section of the ERD, entitled '*Summary of potential breaches of legislation or FSA Principles or Rules*', identified the basis upon which the FSA considered that the statutory threshold test for investigating Mr Cummings was met (paragraph 39a above sets out the statutory threshold test): "*There are circumstances to suggest that Peter Cummings may have breached Statements of Principle 5, 6 and 7 of APER as a result of failings in his responsibilities as an executive Director of HBOS Plc and CEO of its Corporate Division.*"

97. The '*Summary of potential breaches of legislation or FSA Principles or Rules*' also set out a summary of the key facts supporting the investigation:

> "*In summary, the FSA identified in 2007 that the regulatory risk profile of HBOS's Corporate Division was high and that its risk management systems fell short of the standards reasonably expected by the FSA. Under Mr Cummings' leadership, HBOS' Corporate loan book and its risk profile grew considerably throughout 2006 and 2007 when it would have been prudent, given the systems and controls issues identified across the Division, for it to have been exposed to less risk. Mr Cummings was instrumental in the running of HBOS' Corporate division, proposing the strategy and the risk appetite that was endorsed by the Board. In his capacity as CEO he also had responsibility for ensuring the division had systems and controls commensurate to the risks they were taking. Mr Cummings regularly attended Risk Committees and all deals of £250m and above (this limit was lowered during 2008) would have required his personal sign-off*

alongside that of another Executive Director, Colin Matthew. He therefore appears to be personally responsible for its failings."

98. The ERD contained a section entitled '*Reasons for referral, having regard to referral criteria*'. In answer to the question "*Are there issues that indicate a widespread problem or weaknesses at the firm?*", the ERD stated: "*Yes. There are widespread systems and controls weaknesses within the Corporate Division which are detailed in the RMP programme issued to the firm on 17 October 2008. The extensive nature of these weaknesses would indicate that the Group Risk and Group Audit functions were not providing effective second and third lines of defence*". As stated above, Group Risk and Group Audit were not the responsibility of Mr Cummings.

99. Under this same section ('*Reasons for referral, having regard to referral criteria*'), the question was asked: "*Overall, is the use of the enforcement tool likely to further the FSA's aims and Objectives?*". The answer given was: "*Yes, insofar as it would serve as notice to firms and individuals that the FSA is taking the matter of competence and judgment of senior management seriously.*" The same section also referred to the fact that this referral was relevant to "*an FSA strategic priority*", being the FSA's focus on the fitness and propriety of SIFs.

100. The ERD thereby recorded the formal decision (taken by Supervision and Enforcement) to investigate Mr Cummings. In reality, however, the decision to focus the investigation on Mr Cummings appears to have been taken some time prior to the signing of the ERD as a result of a decision-making process that appears to have been an ongoing one from early December 2008. A copy of the ERD is attached at annexe 4.

101. In summary, it is apparent from the documents and from the evidence of the Report interviewees in relation to the decision-making process that:

(a) The trigger for consideration by the FSA of possible enforcement action was the failure of HBOS, rather than the apparent misconduct of any particular individual. This was accepted in their Report interviews by Sir Hector Sants, Ms Cole, Mr Pain, Mr Adamson, Mr Walker, Mr Johnson, Mr Hall, Ms McDermott (who took over from Ms Cole as Director of Enforcement) and Mr Jones (although he and Ms McDermott were not involved in the decision to refer) (paragraph 63 above).

(b) Prior to the signing of the ERD, Ms Williams (Supervision), Mr Jones (Enforcement) and Mr Smith (Enforcement) had each raised the question as to why Mr Cummings was the only person being referred to Enforcement for investigation (paragraphs 72, 82 and 84 above); and it appears that no response was ever received by any of them to this key question. There is certainly no documentary record of this question being discussed and answered; and none of the interviewees recalled any such discussion and answer.

(c) Prior to the signing of the ERD, there was never any proper consideration of an investigation of the failed bank, HBOS. There are no documents which record any such consideration (although the issue was briefly raised in the emails in paragraphs 72 and 74 above), and no interviewee could specifically recall any consideration of this issue. As Mr Adamson put it: "*…we weren't really thinking about the firm at that point. It was against individuals.*"

(d) Prior to the signing of the ERD, there was never any proper consideration of an investigation into any former senior managers other than Mr Cummings. There are no documents recording any such consideration. In their interviews, Mr Adamson was clear that there had been no such consideration, as was Mr Smith who stated "*…the name Andy Hornby rings a bell. Obviously it should ring a bell but I don't think he ever – I don't think his name was ever raised in the context of "Should we also refer him as well?"*". Mr Taylor and Mr Walker could not recall any consideration of other individuals. Ms Williams, by contrast, did think there were discussions about individuals other than Mr Cummings, but could not recall when

these discussions had taken place and could not be sure that they had occurred pre-referral at all; and she did not identify which particular individuals might have been discussed.

(e) None of the interviewees had any recollection as to when, how, and by whom it was decided that Mr Cummings would be the subject of enforcement action. While it appears from the documents that the decision may have taken place on 9 January 2009, none of the four participants at the apparently critical meeting could remember anything about it. The overall view of the interviewees was, in effect, that the decision was taken by means of an iterative process of discussion; but the net result of this was that none of the interviewees took responsibility for the decision.

(f) It was the assumption that the investigation of Mr Cummings was merely a "*starting point*", and that if further evidence emerged in the course of the investigation then other targets could be added, subject to the two year limit. In his interview, Sir Hector Sants said: *"…it seemed that you start with Cummings because he looked superficially the most culpable. And then, by starting that investigation, which then allows you to get into the detail of obtaining material from the firm, you can then expose more thoroughly the question of whether others can at that point be brought into the enforcement process";* and *"[t]here was never any suggestion that, just because you started there,…that's where you finished"*. This view was supported by Supervision: Ms Williams, in her interview, said that her recollection was that Enforcement would *"start with [Cummings] but I don't think we ever agreed that would be it"*; and Mr Adamson, in his interview, explained that he understood that Enforcement, in its investigation, *"…would go up to the chief executive and the board…"*. Similarly, Mr Jones (Enforcement) understood that his role was to start looking at Mr Cummings but that, if failures seemed to extend upwards, others would then be investigated; and that he *"genuinely … expected"* there would be further targets once the investigation into Mr Cummings had been commenced (although he qualified this by saying that "*I didn't know*"). Mr Johnson (Supervision) expressed the view that, while Mr Cummings was the starting point, he expected the "*other equally significant issues*" referred to by Ms Williams in her email of 22 December 2008, to be investigated at some point in time.

C.2 The early stages of the investigation: 27 February 2009 to the end of 2009

102. The issue of potential action against one other former senior manager arose almost immediately after the referral of Mr Cummings. On 27 February 2009, the Chartered Institute of Public Finance and Accountancy ('CIPFA') wrote to Ms Cole (Enforcement) explaining that it was considering starting a major investigation into the conduct of Mike Ellis (the former Group Finance Director at HBOS), on grounds of lack of competence, skill and integrity. The potential investigation would concern Mr Ellis' role in *"compiling and approving"* the accounts of HBOS for the year ended 31 December 2007. This did not, however, ultimately lead to the FSA investigating Mr Ellis:

(a) CIPFA's letter recorded that it considered that there was prima facie evidence that may lead, upon further investigation, to disciplinary action and that the issues related to competence, skill and integrity and therefore overlapped with the FSA's concepts of fitness and propriety. The letter was forwarded by Ms Cole to Mr Pain (Supervision), Mr Adamson (Supervision) and Mr Walker (Enforcement) on 2 March 2009.

(b) On 3 March 2009, Mr Taylor (Enforcement) sent an email to Ms Cole (Enforcement) and Mr Walker (Enforcement), entitled '*SIF holders at major retail banks*', which summarised the position in respect of enforcement action relating to HBOS as follows: *"we are not currently considering any other HBOS SIF holders but we are now aware that the [CIPFA] are considering*

investigating Mike Ellis (Group Finance Director). We will establish what their concerns are and consider if we should initiate our own investigation or (possibly) join any investigation…In the event that our investigation into Cummings suggests personal culpability of other SIF holders we will (with MRGD) consider adding them to the scope of our investigation."

C

(c) As it transpired, the FSA neither joined CIPFA's investigation nor initiated its own investigation into Mr Ellis, although it did agree with CIPFA that CIPFA would provide monthly updates as its investigation proceeded.

(d) It is unclear from the documentary record whether a positive decision was made not to investigate Mr Ellis, or whether the matter was simply not addressed. There are certainly no documents showing any reasoned consideration at this time as to whether or not to investigate Mr Ellis. There is, for example, no document to indicate that the FSA expressly considered at the time whether the statutory threshold test for investigating him was met and, if so, whether it was appropriate to start an investigation. It is, however, noteworthy that, over three years later in April 2012, the FSA did conclude that "*possible investigations we think we could realistically pursue*" would include investigating Mr Ellis (paragraph 253 below). However, by that time, the statutory time limit for bringing disciplinary proceedings against Mr Ellis had almost certainly expired.

(e) In October 2009, the FSA learnt that CIPFA had decided not to investigate Mr Ellis. In about May 2011, Mr Ellis applied to the FSA for approval for the purpose of becoming the Chairman of Skipton Building Society. His application was successful and he was approved as a non-executive director of Skipton Building Society from June 2011. Mr Ellis spoke to Sir Hector Sants shortly after he was given approval (but before he was aware of the decision), querying what the FSA intended to say about the fact that he was the former Group Finance Director at HBOS. Sir Hector Sants confirmed to Mr Ellis that the FSA would go no further than say that the approval process *"takes into account previous employment history"*.

103. On 27 February 2009, HBOS announced its Preliminary Results for the year 2008. These reported a loss of £3.627 Billion in the Treasury Division (including a negative figure of £3.948 Billion for the impact of Market dislocation); a loss of £6.793 Billion in the Corporate Division, including impairment losses of £6.669 Billion; and impairment losses of £958 million in the International Division. These figures showed a considerable deterioration from those contained in the Trading Update of 12 December 2008 (paragraph 68 above), and for the first time showed substantial impairment losses in the International Division.

104. When asked about these Preliminary Results in her Report interview, Ms Williams (Supervision) said: *"…yes, there was information coming out that would seem to reinforce what I'd said earlier in these emails, and also what I said to you, which is: Corporate alone was not the only failing, although in quantum it was certainly the biggest"*. Ms Thomas (Supervision), in her Report interview, confirmed that by late February 2009, *"…we had started to appreciate that there would be a blood bath on international"*, a view that does not appear to have been communicated to Enforcement. Mr Adamson (Supervision), in his Report interview, agreed that these Results suggested that *"…there was a quite fundamental problem with the way that the bank had been run as a whole"*, but added *"I don't think that was particularly new"*. The fact that the FSA knew that there was "*a quite fundamental problem with the way the bank had been run as a whole*" is significant given the limited scope of the investigation conducted by the FSA.

105. Notwithstanding these Preliminary Results, the FSA did not consider whether it was appropriate to extend the scope of the enforcement investigation beyond an investigation into Mr Cummings (including into the former CEOs of the Treasury and International Divisions i.e.

Mr Mackay[30] and Mr Matthew). In the Report interviews, no-one in Supervision could recall having approached Enforcement to discuss whether the scope of the investigation was too narrow in light of these Results. Mr Jones, then in charge of the day-to-day running of the investigation of Mr Cummings, did look at the Results, but only in order "*…to see what it said about Corporate, because that was my job*". Mr Walker, who was the Project Sponsor responsible for the investigation of Mr Cummings, said: "*I wouldn't have looked at information like that. I would have expected the supervisors to be reviewing that sort of information as it came in*". There is, however, nothing to indicate any communication between Enforcement and Supervision about these Results. In his Report interview, Mr Walker said that, if he had known about the losses, he would have tasked the referral team (i.e. Supervision) with finding out the reason for the losses so that they could consider if "*there [is] a parallel issue to corporate*".

106. On 2 March 2009, Ms Cole (Enforcement) sent an email to Mr Walker (Enforcement) asking him to produce a "*work plan and timelines on Cummings*". Mr Jones (Enforcement) was asked by Mr Walker to produce this plan. In his plan, Mr Jones explained that the case was "*…potentially a very complex case and the trick will be keeping focus on the really important issues. So we will investigate the period that Mr Cummings was CEO Corporate Lending (Jan 2006 – Dec 2008) but concentrating first on 2008*". The plan went on to conclude that "*…the approach outlined…will allow [the FSA] to form a view on whether the concerns set out in the ERD appear to be justified*".

107. On 9 March 2009, Mr Jones (Enforcement) circulated to Ms Thomas (Supervision), Mr Walker (Enforcement), Mr Wilson (Manager, in Enforcement) and Ms Williams (Supervision) a '*scoping document*' to be used for the purposes of selecting a consultant to assist with Enforcement's investigation of Mr Cummings. The next day, in a further email to Ms Williams and Ms Thomas, Mr Jones explained the case theory at that time (emphasis added): "*Our theory is that the firm's management should have been aware of the worsening climate by start 2007 and should have looked at its risk appetite at this point and onwards as things changed*". The final version of the draft instructions to the consultants, which was produced on 16 March 2009, explained that part of the investigation would include "*…the role of the Boards, Audit Committee, ALCO and divisional and group risk committees*" as well as "*provide an analysis of impairments reported in the February 2009 statement: How much is attributable to Corporate…*". As well as producing draft instructions relating to the investigation of Mr Cummings, draft instructions were also produced in relation to investigations into two SIFs at two other failed banks (RBS and B&B). The investigations of the three senior individuals became known, collectively, as '*Project Rainbow*'.

108. On 13 March 2009, the FSA met with four accountancy firms for the purposes of inviting tenders for the three investigations comprising Project Rainbow. During the meeting with the accountancy firms the FSA explained that, in relation to HBOS and RBS, the FSA considered that there were "*…two specific business areas where the majority of losses occurred and we are looking at the individuals responsible for these business areas…*". A briefing document prepared by the FSA to provide the accountancy firms with further detail regarding the proposed scope of the three investigations stated: "*The FSA has concerns about the conduct of the three individuals named. The scope of the investigations as set out in the draft instructions is sufficiently wide for the investigating firm to identify the underlying issues in the governance and risk management at the banks whilst focussing on the conduct of the three individuals. The investigating firm will also determine how those individuals interacted with their fellow non executives and senior managers. We will consider whether it is appropriate to place other individuals or the Banks themselves under investigation if concerns about their conduct arise.*"

(30) For ease of reference, Mr Mackay is referred to in this Report as the 'CEO' of the Treasury Division. At the date of the failure of HBOS, Mr Mackay was head of the Treasury Division, just as Mr Cummings was head of the Corporate Division and Mr Matthew was head of the International Division. Mr Mackay had the title of 'Operating Divisional Chief Executive' of the Treasury Division, whereas Mr Cummings and Mr Matthew had the titles of 'Chief Executive Officer' of their respective divisions. Mr Mackay was not on the Board, whereas both Mr Cummings and Mr Matthew were Board members. The Treasury Division was represented on the Board by Mr Mackay's line managers, these having been Mr Hodkinson from the end of 2005 to March 2007, and Mr Matthew from March 2007 until early 2009.

109. On 23 March 2009, the FSA formally appointed investigators under section 168 of the Act in relation to Mr Cummings. The Memorandum of Appointment of Investigators of that date ('MAI') stated that there were circumstances suggesting that Mr Cummings may have failed to comply with Statements of Principles 5, 6 and 7 and may therefore be guilty of misconduct and/or may not be a fit and proper person. The MAI identified the particular circumstances which suggested such failures as including the fact that Mr Cummings, as CEO of the Corporate Division, "*was responsible for managing HBOS Plc's exposure to credit risk arising from corporate lending transactions*", and that "*the credit risk related systems and controls for which Mr Cummings was responsible were not effective*". A copy of the MAI is attached at annexe 5(31). On the same day, Mr Jones informed Mr Cummings by telephone that he was under investigation. The note of the conversation indicates that, in response, Mr Cummings asked whether "*he was the only individual from HBOS under investigation*", but that Mr Jones told him he could not answer that question.

110. Also on 23 March 2009, Mr Walker (Enforcement) briefed Sir Hector Sants (CEO) by email regarding '*RBS, Bradford and Bingley/HBOS: Enforcement work*'. He informed Sir Hector that the referrals of the three individuals, one at each of those banks, had been completed, and that the "*big four accountants*" had been briefed and were coming up with proposals to assist. Sir Hector replied "*thanks fine keep going.*"

111. On 30 March 2009, Mr Walker (Enforcement) briefed Lord Turner (Chairman) in relation to Project Rainbow. In an email to Ms Cole (Enforcement) later that day, Mr Walker recorded that he had explained to Lord Turner the "*…more general issues about action against SIFs (difficulties in taking action for bad judgements, delegation, role of NEDs etc)*". In a further email to Ms Cole on 1 April 2009, Mr Walker added that he had explained to Lord Turner that the referrals of individuals at RBS and HBOS were "*…about the big losses in the areas of the business they were responsible for*", but that the approach the FSA needed to take so as to establish a case against a SIF meant that the issue was "*…reasonable care not just there were losses/problems in the area they are/were responsible for*".

112. On 1 April 2009, Mr Jones (Enforcement) sent an email to Ms Cole (Enforcement) which stated that: "*Inevitably we will need some commitment from the bank [i.e. Lloyds Banking Group] and this will come at a time when they are busy with other high priority work. It is important that we engage with them now to ensure the best co-operation.*" Lloyds Banking Group did co-operate on an ongoing basis.

113. On 16 April 2009, Enforcement, including Mr Walker (Enforcement) and Mr Jones (Enforcement) held a scoping meeting with Mr Cummings and his legal representatives. When asked about this meeting in his Report interview, Mr Cummings took the view that he had not been given an understanding of what it was that the FSA was investigating, having previously been told only that the FSA was investigating his *"management of credit risk"* (consistent with the MAI, paragraph 109 above and annexe 5). During Mr Cummings' Report interview, his lawyer, Tony Woodcock of Stephenson Harwood, explained that this scoping meeting *"took no different form from others"* (i.e. that he had attended) in that *"[y]ou press for information and vagaries tend to be the answers"*.

114. On 21 April 2009, Mr Walker (Enforcement) sent to Sir Hector Sants (CEO) and Mr Pain (Supervision) a report entitled '*RBS/HBOS/Bradford & Bingley Group (BBG): investigation work update*'. In the report, Mr Walker recommended that the FSA appoint Ernst & Young ('E&Y') to investigate Mr Cummings. E&Y's estimated cost was £2.12m (with the total accountancy costs for all three investigations being estimated at just over £6m). The report explained that the

(31) Three further such Memoranda were issued and sent to Mr Cummings (dated 11 May 2009, 5 February 2010 and 21 July 2010). These notified Mr Cummings that further individuals were being appointed as investigators, but did not otherwise alter the substantive wording of the original MAI.

accountants' investigations would be focussed *"…largely on 2007 and 2008. This covers the period when the business areas we are looking at were expanding rapidly and when Markets and the economy started to turn down…For the matters that have been referred to Enforcement, we will be taking forward separate work (eg reviews of FSA files and interviews with the subjects and key witnesses) which will affect our assessment of whether breaches occurred…"*. The report went on to record that: *"We have told the accountants that they should provide us with a written report (or reports) within three months."* Accompanying the report was a table setting out in more detail the scope of the investigation of Mr Cummings. That table explained, among other things, that the investigation *"may identify other SIFs who we should place under investigation"*.

115. Upon receipt of the report and the work scope table, Mr Pain (Supervision) commented by email on 22 April 2009 that the investigation should include consideration of corporate governance and oversight by the relevant executive committee. Andrew Whittaker (General Counsel) stated by email on 23 April 2009 that the work scope needed an explanation of the purposes for which the reports were required from E&Y, which he regarded as being to assist the FSA to decide *"…whether regulation action should be taken against any individual to limit their involvement in regulated activities"* and *"…whether action should be taken in court to recover loss caused or profits gained by any individual as a result of a contravention of FSMA or any requirement imposed under it"*. On 23 April 2009, Sir Hector Sants (CEO) signed off the proposed scope of the investigation, subject to it being approved by others, and he approved the budget for the investigation.

116. Earlier the same day, 23 April 2009, Mr Walker (Enforcement) had asked Ms Cole (Enforcement), in an email, whether he could *"…assume that we will focus on the business areas the individuals were responsible for? This then fits into their responsibilities to control their divisions. If we identify problems in specific business divisions we can then take a decision on whether it is appropriate to broaden the scope."* Ms Cole agreed with this.

117. On 28 April 2009 (i.e. two months after the referral of Mr Cummings), Mr Jones (Enforcement) sent an email to Mr Walker (Enforcement), entitled '*Peter Cummings – 2 month review*', which began by recording that *"We are now 2 months into our investigation and a review of the project is due: this email sets out what has happened on the case and my recommendation that we continue"*. Mr Jones recorded that *"[a]lmost all of our time"* in those two months had been spent on the tendering process which had resulted in the decision to appoint E&Y, but that the FSA had conducted a scoping meeting and was due to interview Mr Cummings shortly. In his Report interview, Mr Jones explained the procedural issues that had caused the tendering process to take two months, clarifying that during those first two months the team had consisted only of him, two junior Enforcement employees, a paralegal and a secretary. Mr Jones's email concluded: *"This case is of the highest priority and the obvious recommendation is that we should continue with a further review point at mid-August once we have absorbed the information obtained over the next 3 months"*. Mr Walker replied on 5 May 2009, stating: *"Thank you for this. I agree."*

118. The FSA's first interview with Mr Cummings took place on 30 April 2009. The interview was very much introductory in tone, being conducted at a relatively high level of generality. Mr Cummings was asked during the interview to give detail as to the growth targets which HBOS had adopted, and he explained that the demands for higher growth had come from HBOS's Group CEO (Mr Hornby) and the Executive Committee. Mr Cummings also said that there was very little, if any, push back from HBOS's Group Risk Division.

119. On 1 May 2009, the Treasury Select Committee published its report into the banking crisis, entitled '*Banking Crisis: dealing with the failure of the UK banks*'. The report considered the positions of B&B, RBS, HBOS, Northern Rock and Barclays. The Treasury Select Committee had taken evidence from a wide range of politicians, bankers, academics, journalists and other interested parties, including Lord Stevenson, Mr Hornby, Lord Turner and Sir Hector Sants. The report concluded that: *"Some banks' management and boards have failed their shareholders and*

created concerns for their customers and this failure has had devastating consequences for the UK's private and public finances." The section on HBOS raised a question as to whether there may have been significant failings by HBOS's Board and, in particular, on the part of Lord Stevenson and Mr Hornby:

> *"The defence put forward by Mr Hornby and Lord Stevenson was that they had recognised the risks posed by the business model and had taken some mitigating actions. Mr Hornby claimed that by 2006-07 HBOS executives "tried to increase deposit growth and grew deposits faster" in order to reduce risk. Lord Stevenson argued that HBOS had reduced its "share of the housing Market from 30% to 20%...out of good countercyclical caution" and "deliberately took a P&L [profit and loss account] hit so as to lengthen the maturity in wholesale Markets". What Mr Hornby did accept was that HBOS had been "over-reliant on wholesale funding" and that the Board "should have done more to reduce this reliance"…*
>
> *In response to the charge that risk management in HBOS was inadequate, Lord Stevenson argued that "HBOS had very elaborate systems of risk management and stress testing, worked out over the years…hand-in-hand with our regulator". Similarly, Andy Hornby contended that he had "listened to siren voices very carefully" and adduced as evidence a number of ways in which HBOS had sought to reduce its risk profile… Mr Hornby did however acknowledge that more could have been done: "If I look back and say what could have been done differently, there is no doubt that if we could have gone even further…that would have been a beneficial situation.""*

120. There is nothing to indicate that this report caused the FSA to consider whether the scope of the ongoing investigation was appropriate. In particular, following this report, there appears to have been no discussion between Enforcement and Supervision (or within either of those departments) as to whether there should be investigations of Mr Hornby and Lord Stevenson.

121. On 6 May 2009, Enforcement held a '*tripartite*' meeting with E&Y and Lloyds Banking Group, who were accompanied by their solicitors, Herbert Smith. This was the first of a series of such meetings. During the meeting, Mr Jones explained that the FSA had *"…not ruled out putting other individuals under investigation. However, [the FSA] will probably not be in a position to consider this until after the accountants have conducted their investigations. They are due to report back to the FSA at the beginning of August. We will inform [Lloyds Banking Group] if this is the case."* The expectation of Enforcement was therefore that it would review the position of other individuals in or around August 2009. When Mr Walker was asked in his Report interview as to whether this was a realistic approach given the ongoing running of the two year statutory time limit for bringing disciplinary proceedings, he said that *"…two years was always tight…on these cases"*, but that the time limit for proceedings against other individuals may not have begun at the same time as it had begun against Mr Cummings. He did not suggest, however, that anyone within the FSA had actually considered whether different time limits applied to different individuals, and there are no documents to suggest that anyone considered this.

122. On 15 May 2009, the FSA entered into a contract with E&Y for it to *"to provide consultancy services relating to an investigation of HBOS"*. The contract term was from 11 May 2009 until *"… completion of the services, expected to be 11 August 2009"* (this ultimately proved to be very optimistic). The scope of the contract was determined by reference to two proposals from E&Y dated 27 March 2009 and 27 April 2009. E&Y's services related to the Corporate Division, covering the period from 1 January 2007 to 31 December 2008. E&Y's services were also to involve an analysis of the financial disclosures made in the June 2008 Rights Issue and the November 2008 Placing and Open Offer (collectively referred to in E&Y's contract and below as 'the Rights Issues'), this not being part of the section 168 investigation into Mr Cummings. The *'Instructions to Consultants'* which were given by the FSA to E&Y stated that their activities had two "*General Objectives*", being:

"• to provide factual analyses and information that will assist us to decide whether disciplinary or other regulatory action should be taken against Peter Cummings (e.g. public censure, financial penalty, prohibition and/or restitution);

• to provide factual analyses and information that will assist the FSA for the purpose of its supervisory functions in understanding the processes followed by HBOS in the Transactions and the role played by senior management in those processes."(32)

123. On 28 May 2009, the FSA's Board was formally told by Sir Hector Sants (CEO) of the start of enforcement investigations into three individuals including Mr Cummings, one at each of the three '*Project Rainbow*' banks.

124. On 29 May 2009, Enforcement sent a memo to the FSA's Investigation Powers Expert Group, entitled '*Project Rainbow – section 66 time limit issues*'. The memo set out general observations as to how the limitation period in section 66 of the Act (paragraph 28 above) might apply to misconduct cases involving a failure to comply with a Statement of Principle, and was intended to be used to assist the Project Rainbow investigation case teams to identify and manage time limit issues arising on the facts of their specific cases. Enforcement's memo warned that (emphasis added): *"In a complex case, it may not be possible to formulate the instances of misconduct (if any) and corresponding time limits until the investigation has reached an advanced stage. Time limit issues should therefore be kept under regular review as the investigation progresses."* This was an important warning and made clear why it would be unsafe simply to assume that time would expire in relation to other former senior managers (such as Mr Hornby and Lord Stevenson) at any later date than in the case of Mr Cummings.

125. On 9 June 2009, Enforcement held an interview with Colin Matthew (CEO of the International Division at the date of the failure of HBOS). Mr Matthew attested, as had Mr Cummings, to the role of Mr Hornby in setting growth targets.

126. Also on 9 June, the FSA held a weekly ExCo meeting which was attended by, among others, Sir Hector Sants (CEO), Ms Cole (Enforcement) and Mr Pain (Supervision). The minutes of the meeting record discussion of Mr Hornby, in the following terms (emphasis added): "*Following discussion it was agreed that the FSA did not have any additional information that was not publicly available that would justify any further action in respect of Andy Hornby and any prospective new employment. Although his actions while at HBOS had been investigated, Mr Hornby had not yet been disqualified. This position would, however, be reconsidered once the FSA's investigation had been completed."* None of the Report interviewees was able to explain the underlined words. No investigation had been carried out into Mr Hornby's conduct. The reference to his *"actions while at HBOS"* having been *"investigated"* was therefore, as both Sir Hector Sants and Ms Cole accepted in their Report interviews, clearly wrong. The explanation offered by Sir Hector Sants and Ms Cole was that this was an example of poor minute taking, with Ms Cole stating that she could not make sense of the minute and that it was *"just a poorly drafted minute all round"*. Sir Hector Sants also stated that, while the minute was "*technically inaccurate*", he believed that the "*question over Hornby's involvement, and the potential for enforcement action, had been properly considered and kept under review*". In his Report interview, Mr Pain said that the minute was not *"entirely correct"* but that he thought that, during the course of any investigation of Mr Cummings and the Corporate Division, the culpability of other related individuals had been considered. This was a significant error in an ExCo minute.

127. On 11 June 2009, Mr Walker (Enforcement) sent a '*Note*' to Ms Cole (Enforcement) which was intended to provide "*…an update on our work on the three banks and associated individuals*". The

(32) The capitalised term '*Transactions*' used in the last sentence above was not in fact defined, but all Report interviewees who were asked about it confirmed that it was a reference to the Rights Issues. For the purpose of the work on the Rights Issues, the FSA exercised its power under section 165 of the Act requiring HBOS to provide specified information and/or documents. It was not, therefore, an investigation under sections 167 or 168.

Note recorded the FSA's original expectation to receive reports from the accountants in late August (assuming full bank co-operation), but that the *"deadline is under pressure"* due to delays in responding to document requests.

128. On 25 June 2009, E&Y prepared an interim discussion document for the FSA. The document contained high level initial observations. One of the *"key themes emerging"* which had been identified by E&Y was *"Application of the 'three lines of defence' governance structure"*. A further issue was the extent to which its investigation should focus on Mr Cummings: "*Focus on PC v consideration of role of others/firm.*" However, this does not appear to have resulted in any real consideration of that issue. Indeed, Mr Hornby and Lord Stevenson were listed merely as being *"Possible future interviews"*. Mr Jones and Mr Walker each stressed in their Report interviews that this was simply the view of E&Y, and that their own view was that interviews with those two individuals were essential.

129. On 29 June 2009, Ms Williams (Supervision) sent an email to Ms Thomas (Supervision), copied to Mr Hall (Supervision) and Mr Johnson (Supervision), entitled '*HBOS International*'. The email stated as follows (emphasis added):

> *"I understand that HBOS's international wholesale/corporate businesses are performing as poorly as the UK business formerly headed by Peter Cummings. Although [Cummings] was not responsible for the International businesses, the two divisions shared similar business models in corporate lending and in some cases similar systems and controls…The Head of International and Strategy, Colin Matthew, was responsible for the overall strategy of the Group and was co-signatory on large corporate exposures with [Mr Cummings]…Given this degree of overlap and in view of our decision to refer [Mr Cummings] to enforcement, I wondered if you had any plans to do the same for Matthews. As the businesses he ran were non UK, I am less familiar with our jurisdiction to pursue this but if we were to do so, I would be happy to help the team as best I can in building up a fuller case."*

130. In her Report interview, Ms Williams explained that she no longer had a supervisory role in relation to HBOS at the time of sending this email (Ms Thomas being the Manager in Supervision responsible for Lloyds Banking Group), but had decided to raise the issue as a matter of good practice. As she put it (emphasis added): *"I don't know if it stemmed from the feeling it would be unfair, but it stemmed more from the feeling that there were other directors accountable for the failings in this firm, and that if we had the opportunity to take action against others, I probably felt we should have done"*.

131. In their Report interviews, none of the recipients of this email (Ms Thomas, Mr Hall and Mr Johnson) could remember having received it; and none appears to have taken any action upon receiving it. There were no email responses from any of those individuals to Ms Williams. In her Report interview, Ms Thomas, to whom the email was directed, said that *"…the only thing I can think of is it got lost in my inbox"*. There is no record of the email having been sent to Enforcement, although Mr Jones recalled in his Report interview that *"I remember [Ms Williams] saying to me when I bumped into her in the lift shaft somewhere that, you know, "International is starting to look quite heavy in terms of impairments. That's worrying, isn't it?""*. Mr Jones stated, however, that he was focussing on the investigation into the Corporate Division and Mr Cummings, and would have relied upon Supervision to have identified other targets for investigation: *"It was…simply wasn't my job to be thinking about looking at information other than the stuff that I was gathering in in the investigation."* In his Report interview, Mr Hall (who had taken over responsibility for the supervision of HBOS from Mr Johnson in mid-January 2009) made the point that Supervision was, at this time, experiencing enormous resourcing problems, and he referred to the extreme "*exhaustion levels*" within the department. Ms Thomas also highlighted the very considerable workload with which she was dealing at this time.

132. It therefore appears that despite Ms Williams (the Manager in Supervision previously responsible for HBOS) having raised a specific query about whether enforcement action should now be considered in relation to the International Division and/or Mr Matthew, no further consideration was given to the matter. Indeed, there is no evidence that any discussion took place within the FSA on this matter at this time.

133. On 20 July 2009, Mr Walker (Enforcement) received an email briefing from a junior Enforcement employee regarding the ongoing investigation into Mr Cummings, for the purpose of a note which Mr Walker was preparing for ExCo. The email explained that both informal and formal discussions had been carried out with individuals connected to HBOS and that a greater understanding had been achieved regarding how the three lines of defence were said to operate in practice. The email recorded that *"…Group Risk was particularly weak in relation to credit risk (this may serve as mitigation for Cummings…)"*. Group Risk was part of the second line of defence.

134. On 28 July 2009, ExCo held a meeting which discussed, among other things, the ongoing investigation of Mr Cummings. An '*ExCo Summary Paper*' authored by Mr Walker (Enforcement) explained that it was anticipated that there would be *"…overruns in timing at all banks and budget overruns at RBS"*.

135. On 30 July 2009, E&Y produced a second interim discussion document. E&Y recorded that additional formal interviews had been put on hold *"…until comprehensive documentation sets received/document plan and prioritisation undertaken"*. The discussion document focussed on corporate governance, accounting and risk management, and contained no reference to investigating anyone other than Mr Cummings. It identified as work in progress: *"Focus direction of work to prove/disprove culpability of Mr Cummings"*.

136. On 6 August 2009, E&Y produced a draft case theory concerning Mr Cummings. At this stage, the *"1/1/07 business plan"* was described as *"OK – No Substantial Criticism"*, and the failings were perceived as arising at a later stage, in view of poor controls on new deals, poor control of relationship managers, poor management information, and a failure to react to changing circumstances. The case theory was later updated and expanded upon in September 2009.

137. On 20 August 2009, E&Y provided the FSA with a further report. This report noted that a key area requiring further investigation was the accuracy of the disclosed Corporate Division impairment losses, and that this raised a need to understand whether Mr Cummings had complied with his statutory duties. It also indicated that the HBOS Board had been aware of credit provisioning issues within the Corporate Division as early as July 2008.

138. On 1 September 2009, Sir Hector Sants (CEO) wrote a letter to Lord Myners (Financial Services Secretary to the Treasury), entitled '*FSA Investigations: Large Retail Banks*'. Having dealt with RBS, HBOS, B&B and Northern Rock, he concluded with a section headed '*Implications for other executives*', stating that: *"In respect of the other firms covered by these investigations we will, once we have concluded the work, consider the implications of our findings in respect of other executives including the CEOs and the Boards."* Given the two year statutory time limit and the delays in E&Y's investigation, the prospect of bringing disciplinary proceedings against any former senior managers of HBOS other than Mr Cummings was plainly diminishing by this time.

139. On 14 September 2009, Mr Walker (Enforcement) sent Ms Cole (Enforcement) a briefing regarding various investigations, including the investigation into Mr Cummings. Mr Walker explained that a report was now expected from E&Y at the end of October 2009; and that timing issues might arise if the investigation were to be expanded into other individuals. In relation to the Project Rainbow investigations (i.e. including the investigation into Mr Cummings), he stated (emphasis added): *"…clearly we have an interest in keeping the accountants (and enf resource) focussed on gathering evidence that will take forward the*

investigations into the 3 individuals. Any expansion of the scope of our investigations into other individuals will also impact on timelines. You should also be aware that the accountants have all underestimated the amount of time and complexity associated with an enforcement investigation."

140. On 16 September 2009, E&Y produced a draft report for the FSA, entitled '*Havana: Rights Issue workstream*'. '*Project Havana*' was the name given to the investigation arising from the failure of HBOS. This substantial document analysed the adequacy of the disclosures made by HBOS in relation to the Rights Issues. As stated above (paragraph 122), this was not part of the investigation into Mr Cummings although it noted that *"specific areas of [the] work and findings to date may be linked to the objectives of the ongoing…investigation of Mr Cummings"*. The '*Conclusion*' in the report identified matters which might be the subject of "*further investigation*", one being: "*The accuracy of the disclosed level of Corporate impairment losses in…public documents.*" The link referred to was that E&Y had noted that Corporate impairment losses were neither quantified nor discussed in the Trading Update for the June prospectus, and that this overlapped with the issue being investigated in relation to Mr Cummings that the Corporate Division was slow in recognising and reporting stressed assets in the period between April and December 2008. Having received the report, the FSA asked E&Y to suspend work on the Rights Issues pending a decision by the FSA's senior management as to whether this work should continue independently of the investigation into Mr Cummings.

141. On 22 September 2009, Lord Myners replied to Sir Hector Sants' letter of 1 September 2009. He stated (emphasis added): *"I regard the proper investigation of the events which have led these banks to the predicament that they are in – and appropriate follow up action – as crucial to the maintenance of public confidence in our regulatory system, especially given the large sums of public money that the taxpayer has either had to inject into them or risk through contingent liabilities. It would be wholly unacceptable for any individuals who have materially breached regulatory or other legal requirements to escape the consequences of their actions, and we must send this message clearly once enforcement action has concluded. Clearly, it is for the FSA to determine the scope of its investigations and how to proceed in the light of their findings. I would urge you, however, to be ambitious in scope and as thorough, quick and rigorous as possible"*. This letter was sent by email to Ms Cole (Enforcement) and Mr Walker (Enforcement) on 24 September 2009.

142. The message which had been delivered by Lord Myners was quite clear – the FSA was being encouraged by the Government to be ambitious in the scope of its enforcement investigations, given the public interest dimension in relation to HBOS and the other failed banks. Sir Hector Sants agreed in his Report interview that the message was to be ambitious in scope. When asked in her Report interview about this letter, Ms Cole said that the investigation of Mr Cummings alone was indeed *"…ambitious in scope, given that this wasn't the only thing that was going on…I felt it would have been less ambitious, and ducking the issue somewhat, to have gone against the firm"*. Mr Walker delivered the same message in his Report interview: *"…I then felt at the time with this portfolio of cases that I was taking that we were quite ambitious."*

143. In around October 2009, Phil Hodkinson made an application for approval as a SIF at Friends Provident. On 21 October 2009, an internal email from Enforcement explained that "*Phil Hodkinson was Group Finance Director and a member of the HBOS Board and Exco. He retired from HBOS in April 2008. He's not someone we are currently thinking of taking action against…"*. Mr Hodkinson's application was successful and he became a non-executive director in late 2009. It does not appear that, by this time, the FSA had considered whether Mr Hodkinson, as former Group Finance Director was a realistic subject for investigation. However, in April 2012, the FSA did conclude that "*possible investigations we think we could realistically pursue*" would include investigating Mr Hodkinson (paragraph 253 below). However, by that time, the statutory time limit for taking disciplinary action against Mr Hodkinson had almost certainly expired.

144. On 19 October 2009, Enforcement took advice from Leading Counsel on the proper interpretation and application of the two year statutory time limit (paragraph 28 above), in the context of the investigation of Mr Cummings. The effect of the advice was that the FSA should proceed on the basis that it would have had knowledge from which misconduct could reasonably be inferred, thereby starting the two year time limit running, when it had knowledge of facts sufficient to establish a prima facie case or a case to answer. It was not until March 2010, however, that the FSA finalised its consideration of the limitation issue, deciding that it should issue any Warning Notice to Mr Cummings by mid-June 2010. That date was, however, later extended following the Financial Services Act 2010 which extended the time limit to three years.

145. On 18 November 2009, a meeting was held between Enforcement and the FSA division responsible for listings (as well as being the UK's financial services regulator, the FSA was also the UK Listing Authority). The meeting was to discuss E&Y's report regarding the Rights Issues (it was no longer a draft report). A meeting note records that, during the meeting, Mr Jones outlined the findings of E&Y's work "*…and our concerns regarding the accuracy of the MI [i.e. management information] which was provided by Corporate to Group. We were concerned that this inaccurate MI was contained in the June Rights Issue prospectus and the October Placing Open prospectus*". He also explained that, since Mr Cummings was responsible for the corporate management information, it made sense to bring this matter within the scope of the investigation into Mr Cummings. Following this meeting, the issue about corporate management information was indeed brought within the scope of the investigation into Mr Cummings. No separate work continued in relation to the Rights Issues.

146. The meeting note then records a discussion of Enforcement's view as to extending the investigation to other directors (emphasis added): "*We have also been asked to consider if there are any potential cases into any Group directors. Our current thinking is that once we have established the extent of the case against Cummings, we will consider whether it might be appropriate to open an investigation into Andy Hornby. This would probably be for omissions in his oversight of Cummings and the Corporate division, and potentially any failings at Group for what was contained in the prospectuses.*"

147. By the end of 2009, the FSA's investigation of Mr Cummings had been ongoing for ten months. During those ten months:

(a) A considerable body of further information had emerged from HBOS which confirmed the earlier indications that the problems had been by no means restricted to the Corporate Division. Indeed, in June 2009 Ms Williams, the Manager in Supervision formerly responsible for HBOS, had specifically raised the point that the International Division was now experiencing such severe losses that enforcement action ought logically to be considered against Mr Matthew (paragraph 129 above).

(b) There was, however, no consideration of expanding the scope of the investigation to include other individuals. Most noticeably, there seems to have been no co-ordinated consideration by Supervision and Enforcement of the emerging further information, and whether it justified expanding the investigation to, for example, Mr Ellis (paragraph 102 above), Mr Matthew (paragraphs 105 and 129 above), Mr Mackay (paragraph 105 above), Mr Hornby (paragraph 120 above) or Lord Stevenson (paragraph 120 above).

(c) It appears that, instead, the intention of the Enforcement investigation case team was to reconsider the position of other HBOS former senior managers once E&Y had completed its other investigatory work. Indeed, Sir Hector Sants' letter of 1 September 2009 to Lord Myners stated: "*…we will, once we have concluded the work, consider the implications of our findings in respect of other executives including the CEOs and the Boards.*"

C.3 The FSA's consideration of investigating Mr Hornby: January to March 2010

148. In early 2010, the Enforcement investigation case team decided to consider whether it should investigate Mr Hornby in relation to his oversight of the Corporate Division. In his Report interview, Mr Jones said: "*Well, we were hugely busy – my view and the view I think expressed to Mr Walker was, you know, we're looking at this, one of the reasons we wanted that decision in early 2010 was that we felt it was the last possible date for us to start an investigation into Andy Hornby and stand a chance of getting a warning notice issued by the middle of 2010 – it was still two years at that time – and therefore be able to fine Andy Hornby.*" So the Enforcement investigation case team appreciated that, by reason of the statutory time limit, any investigation of Mr Hornby's oversight of the Corporate Division was now a matter of urgency.

149. The decision to consider investigating Mr Hornby was recorded in a briefing note sent on 5 January 2010 to Sir Hector Sants by Mr Walker, ahead of a meeting which Sir Hector Sants was due to have with Lord Myners. In that briefing note, Mr Walker stated: *"We have asked E&Y for a view on whether the information obtained to date could form the basis of a case against Andy Hornby. It may be that the information we currently hold provides the grounds for a case based on his failure to control the Corporate Division. We plan to form a view on whether to commence a formal investigation by end January/early February."* The scope of the potential investigation being considered did not, therefore, extend to Mr Hornby's conduct in relation to any other aspect of the business of the failed bank. It does not appear from the documents that Enforcement engaged with Supervision to discuss the potential scope of any investigation of Mr Hornby.

150. Also on 5 January 2010, E&Y produced a document entitled '*Project Havana – High-level review of evidence in respect of Andy Hornby*'. The document recorded that E&Y had been asked to provide an initial view as to the culpability of Mr Hornby, based on the evidence gathered for the purposes of the investigation into Mr Cummings.

151. On 6 January 2010, Mr Jones sent an email to Ms Cole, copied to Mr Walker, which stated: *"Following completion of the investigative phase of the work into the conduct of Peter Cummings, we have asked the EY team to consider whether the information obtained to date could provide a basis for an investigation into Andy Hornby"*. Mr Jones made clear that the focus would be on *"Hornby's oversight of the Corporate Division"*. Mr Jones recommended this course of action on the basis, among others, that *"…we do not expect to conduct major investigative work following EY's report: perhaps only minor information requests to HBOS and interview(s) with Hornby"*. In fact, key individuals such as Mr Hornby and Lord Stevenson had not yet even been interviewed. Mr Walker and Mr Jones said in their Report interviews that the reference to the investigative work being largely complete was to E&Y's investigative work, E&Y not being responsible for conducting the interviews.

152. On 15 January 2010, E&Y provided a document to the FSA entitled '*High-level review of evidence in respect of Andy Hornby*'. A revised version of this document was circulated by E&Y on 21 January 2010. The '*Executive summary*' of the document stated: "*Key matters identified from high-level review of evidence obtained to date in relation to the investigation into Mr Cummings are: Mr Hornby was responsible for setting direction of Group and implementing strategy [including] – the business plan was geared toward growth – Mr Hornby had overall responsibility for systems & controls but did little to define the improvements needed to cope with expansion…- Mr Hornby's focus was not on Corporate…- Insufficient challenge to information and events throughout 2008 [including] Group did not focus on Corporate impairments until Q4 2008.*" The document suggested that possible next steps included interviewing Mr Hornby, and it set out various areas for discussion with him.

153. In their Report interviews, Sir Hector Sants, Ms Cole, Mr Walker and Mr Jones all accepted that the E&Y report had raised serious and/or important issues in connection with Mr Hornby's direction of HBOS. Mr Jones stressed, however, that the '*Executive summary*' may have made the report look worse than a full reading would justify: *"…if this is a list of things that have been identified as potentially things that we could investigate that are listed on their own in this sort of way, yes, it looks terrible. If you read the whole document, I think, to be fair, it gives a more balanced view of, well, yes, you could think about those things but. But, yes, I mean, on their own they are serious issues that have been raised, yes."*

154. In early February 2010, after receipt of the E&Y report, the Enforcement investigation case team prepared a draft memorandum about Mr Hornby for Ms Cole, entitled '*Project Havana – Andy Hornby*'. The memorandum was intended to set out what an investigation into Mr Hornby might look like and what areas the FSA could focus on if an investigation was appropriate:

(a) The memorandum explained why the FSA might choose to investigate Mr Hornby, being that: *"AH had overall responsibility for setting strategy for the Group and each Division – Aggressive growth targets were set for the Corporate Division – AH was, or should have been, aware that growth targets were aggressive and achieving these targets would involve taking on significant sub-investment grade assets in a book that was heavily skewed to property; and – AH does not appear to have taken sufficient steps to ensure that the systems and controls at Group level and in the Corporate Division were equipped to deal with the additional risk and, as a result, Corporate Division found itself poorly placed to deal with the credit crunch and lost in the region of £10bn…The failings we could allege against AH are, therefore, around a failure to oversee a significant part of the business. It is, however, arguable that this failure (if one existed) goes wider than the CEO (eg other senior executives, notably Head of Risk and the FD, and possibly non-executive directors), although it would be more difficult to attribute the same level of responsibility to non-execs who would have received less information."*

(b) The memorandum stated that given the known problems with controls within the Corporate Division, *"it was crucial that Group controls, which were expressed as being AH's responsibility, were strong. The Group referred to this as the "second line of defence" and we regard this as a weak control because of the limited role of Group Risk in challenging Corporate"*.

(c) The memorandum nevertheless cautioned that *"it is unlikely that we will easily locate significant documents to give direct evidence of AH's personal culpability. We would, therefore, need as a first step to interview AH and other directors"*.

155. At some point in February 2010, the memorandum was updated to include the following conclusion (emphasis added):

> "*It appears that the low evidential hurdle test for launching an investigation is met. We would, however, be relying on interview evidence providing us with pointers targeted towards e-mail and document searches. This may prove resource intensive and, based on previous SIF cases, carry a high risk that we will not find significant new evidence to support a misconduct case within the timeframe permitted by section 66(4) of FSMA. In addition, it is likely that we will be drawn into a difficult position of seeking to separate AH's behaviour from that of the Head of Risk and Group FD. There is, of course, the argument (not without merit) that it is right for the FSA to focus its limited resources on the most senior culpable manager.*"

156. Mr Walker said in his Report interview that he had drafted this paragraph and that the phrase *"the most senior culpable manager"* was a reference to Mr Hornby. In his Report interview, Mr Jones agreed that the view of the Enforcement investigation case team was that "*the low evidential hurdle test for launching an investigation*" into Mr Hornby was met. As he put it: *"… everybody thought that the threshold had been met."* This was a reference to the statutory threshold test under section 168 of the Act i.e. that "*it appears*" to the FSA that "*there are*

circumstances suggesting" that *"a person may be guilty of misconduct…"* (paragraph 39a above). Given that the statutory threshold test was met, the FSA's stated policy as set out in the Enforcement Guide (paragraphs 42 and 43 above) was that it would then decide whether to carry out an investigation *"after considering all the relevant circumstances"*.

C

157. On 10 February 2010, members of the Enforcement investigation case team met with Enforcement's Legal Group. A handwritten note of that meeting suggests that their discussion concerned Mr Hornby, and recorded that there is a *"[c]ase to answer but v. difficult and timing issues – also impact on Cummings case. No current need to interview him in Cummings inv."*. This appears to suggest that, although the statutory threshold test for investigating Mr Hornby was met, any disciplinary proceedings would be difficult to win; that such disciplinary proceedings might run up against the two year statutory time limit; and there might be some "*impact*" on any disciplinary proceedings against Mr Cummings. The view also appears to have been expressed that there was no present need to interview Mr Hornby for the purposes of the investigation into Mr Cummings.

158. On 12 February 2010, Mr Walker sent an email to Mr Pain (Supervision), entitled '*Update for Jon on Lloyds Cummings case'*, stating: *"We are currently considering whether it is appropriate to place Hornby and other Group Senior executives under investigation. We will finalise our recommendation on this next week."* When asked in his Report interview about the *"other Group Senior executives"*, Mr Walker could not recall to whom this phrase referred. There is no evidence, apart from this email, that any other "*Group Senior executives*" were being considered for investigation at this stage.

159. On 1 March 2010, Mr Jones sent an email to Mr Walker, entitled '*Cummings/HBOS'*, which asked: *"Can you chase Margaret re Hornby please?"* Mr Walker replied later the same day, stating *"done"*. When asked about this email exchange in their Report interviews, both Mr Walker and Mr Jones explained that the word *"done"* simply reflected that Mr Walker had chased Ms Cole, but that it did not mean that any decision concerning the investigation into Mr Hornby had actually been taken. The FSA's policy regarding decision-takers (paragraph 40 above) meant that, in normal circumstances, the decision would have been for Mr Walker, as Project Sponsor of the existing investigation.

160. It is, however, apparent that, at around this time, a decision was taken not to investigate Mr Hornby. There is, however, no contemporaneous record of the taking of that decision, when it was taken, the reasons for the decision, or by whom it was taken. Indeed, the Report interviewees were, for their part, unclear and indeed inconsistent as to how the decision was taken, by whom and for what reasons:

(a) Ms Cole's recollection was that Mr Walker had taken the decision. Her view as to Mr Walker's reasoning was as follows (emphasis added): *"…I think the decision was let's see what he [i.e. Mr Hornby] says in interview; unless we can find some further kind of tangible – more tangible evidence, we couldn't we – they didn't feel they could guarantee bringing a case against Hornby that would succeed and that was how I was testing these things"*.

(b) Mr Jones's understanding was that Ms Cole had taken the decision, after having taken the matter to ExCo. His recollection of the reasoning was that Ms Cole and ExCo had formed the view that on balance it was not a *"winnable case"*. This accorded with the recollection of Sir Hector Sants, which was that Ms Cole had recommended no action on the basis of a *"clear, unequivocal conclusion"* that *"there wasn't a case"*. There were, however, no ExCo papers or minutes recording any such discussion or recommendation.

(c) Mr Walker initially said that *"I felt it was my decision, but one which I'd…raised with Margaret"*, but immediately corrected that by saying that *"I think it was more sort of Margaret and I actually, probably"*. He then said: *"I think it was probably her and I is how I*

would characterise it. I was closest to it, but then she was the Director of Enforcement and this was an important thing". He could not remember how he and Ms Cole had taken that collective decision. He summarised the reasoning as being: *"I think when we looked at it, I was of the view that the investigation didn't – I didn't think the investigation would prove successful."*

161. The only near-contemporaneous document which contains any account of the reasons for the decision not to investigate Mr Hornby is a draft undated FSA document headed '*Halifax Bank of Scotland*'(33). This document stated (emphasis added): "*E&Y provided a report on whether the information obtained to date could form the basis of a case against Andy Hornby, and what further work might be needed. We have decided not to commence a formal investigation as the E&Y report raised doubts as to whether a sufficiently strong case could be made out.*" This sentence is surprising given that the E&Y report had not "*raised doubts as to whether a sufficiently strong case could be made out*"; and, on the contrary, as a number of the Report interviewees accepted, had raised serious and/or important issues about Mr Hornby's direction of HBOS. Mr Walker, in his Report interview, when asked whether E&Y had expressed doubts as to the viability of a case against Mr Hornby, said: "*I don't remember them explicitly expressing doubts about the case.*" He also said that this was not a document that he recalled having seen at the time.

162. On 24 March 2010, Enforcement conducted an interview with Stewart Livingston (Managing Director of Risk from 1 July 2007, and Chief Risk Officer from January 2008, both within the Corporate Division). During the course of the interview, Mr Livingston stated that the key metric within the HBOS business was profit growth, and that there was *"always big challenge"* to deliver significant profit growth of about 20% per annum. He explained that he had told Mr Hornby in March 2007 that the Corporate Division was (1) over-concentrated in property, (2) over-concentrated in single names and (3) had too much equity. Mr Livingston furthermore described severe pressure from Mr Hickman (Group Risk Director) and Mr Hornby in October and December 2008 to get impairment figures down, stating that Mr Hornby was *"really quite aggressive"*, *"very agitated"*, *"shouting … or certainly getting very loud"*, and had *"exploded"*.

163. On 30 March 2010, Enforcement produced a paper for the FSA's ExCo which included an analysis, under the heading '*Other Directors*', of a possible case against Mr Hornby *"based on his failure to oversee the Corporate Division"*. The paper observed as follows (emphasis added): *"It is, however, arguable that this failure (if one existed) goes wider than the CEO (eg other senior executives, notably Head of Risk and the FD, and possibly non-executive directors). After careful consideration we have not put Mr Hornby under investigation because it is unlikely further work will identify the necessary evidence. To pursue this case we would have to rely on interviews providing us with pointers towards relevant e-mail and document searches. This is likely to prove resource intensive and, based on previous SIF cases, carries a high risk that we will not find significant new evidence. In addition, it is likely that we will be drawn into a difficult position of seeking to separate Mr Hornby's behaviour from that of other directors. It may, however, be the case that further information on Hornby arises as we finalise our investigation."* This paper did not mention the fact that Enforcement had concluded that the statutory threshold test for investigating Mr Hornby was met; and Sir Hector Sants, in his Report interview, said that no-one had told him that Enforcement considered that the statutory threshold test had been met.

164. In summary, by the end of March 2010, the FSA had concluded that the statutory threshold test for investigating Mr Hornby was met, but had decided not to conduct such an investigation. On the basis of the FSA's own guidance, having concluded that the statutory threshold test was met, it should have decided whether to investigate Mr Hornby in the light of "*all relevant circumstances*" (paragraphs 42 and 43 above). However, on the basis of the available

(33) In an index to the documents provided by the FCA for the purpose of this Report, this particular document was referred to as a '*draft ExCo Report*' dated 18 March 2010. No finalised version appears to have been sent to ExCo. It is unclear whether a finalised version was ever sent to ExCo.

documents, it is not possible to determine who took the decision, when it was taken, how it was taken, what were the factors taken into account, or for what precise reasons it was decided not to investigate Mr Hornby. Although the paper produced for ExCo dated 30 March 2010 referred to a "*careful consideration*", there is no documentary evidence recording or reflecting any such careful consideration. Nor was there a sufficiently consistent or clear recollection on the part of the Report interviewees to assist in this regard.

165. The general consensus from the Report interviewees was that any disciplinary action which might ultimately have been brought against Mr Hornby, after investigation, would almost certainly not succeed, particularly if challenged in the Upper Tribunal. As Ms Cole put it: *"…they didn't feel they could guarantee bringing a case against Hornby that would succeed and that was how I was testing these things"*. It appears that this was probably the driving factor in deciding not to investigate Mr Hornby. However, no-one involved in making this decision appears to have considered whether it was appropriate to conclude, before even starting an investigation into his conduct (as distinct from that of Mr Cummings), that a disciplinary case against Mr Hornby would almost certainly not succeed.

166. Furthermore, there is no evidence to indicate that anyone involved in the decision expressly considered the message/tone set by the FSA's senior management as to the importance of ensuring that *"any enforcement action that could be taken here should be taken"*; nor that anyone expressly considered whether, in the light of the other problems within the failed bank, there was justification for a wider investigation into the conduct of Mr Hornby i.e. beyond his oversight of the Corporate Division; nor that anyone expressly considered whether there was a particular public interest in investigating Mr Hornby, as the former CEO of this failed bank. These are matters that should have been weighed in the balance when making the decision.

C.4 Continuation and conclusion of the investigation: late March 2010 to February 2011

167. In early 2010, E&Y began reporting to the FSA its factual findings in relation to Mr Cummings (doing this by providing draft sections of a report). E&Y's full draft report was sent to Enforcement on 25 March 2010. It was a substantial piece of work. Importantly for present purposes, the draft report made clear that growth targets for the Corporate Division had been revised upwards, very substantially, by Mr Hornby and at Group level. This confirmed the witness evidence which the FSA had received.

168. On 29 March 2010, Enforcement produced a *'Memorandum on the limitation period in Havana'*. The memorandum identified three possible dates when the statutory limitation period might be said to have begun for the purpose of disciplinary proceedings in relation to the Corporate Division. The earliest date was 19 June 2008, when the FSA's Prudential Risk Division had conducted a three day visit to review the Corporate Division's credit risk controls. On that basis, in order to be safe, a Warning Notice had to be issued before 19 June 2010.

169. On 30 March 2010, Enforcement produced the paper for ExCo (paragraph 163 above). This set out the potential failings that Enforcement considered could be drawn from the E&Y draft report:

(a) Mr Cummings was alleged to have encouraged the Corporate Division to pursue a strategy into Q4 2007 of aggressive growth of the book (in particular exposure to high value, highly leveraged sub-investment grade loans to the property and construction sectors) despite knowing that areas of credit risk controls were weak. It was alleged that Mr Cummings had not reasonably assessed or mitigated the risks involved.

(b) Mr Cummings was alleged to have failed to introduce systems to ensure that complex and high value transactions were subjected to appropriate monitoring to identify and/or mitigate impairment losses on a timely basis. Enforcement said that there were, therefore, inadequate controls to ensure that problems with high value transactions were promptly and accurately recorded in management information used to prepare HBOS's financial statements. This was despite serious issues having been identified in this area in Q2 2007.

(c) Mr Cummings was alleged to have made decisions regarding provisioning levels on high value loans without adequately testing the plausibility of workout projections.

(d) Mr Cummings was alleged not to have ensured that the quality of credit risk analysis, or to have ensured that challenge, was adequate before completing high value deals. This was said to have resulted in decisions (which Mr Cummings signed off) being based on inadequate information and processes.

170. On 13 April 2010, Enforcement interviewed Mr Cummings (this being his fourth interview). During the course of this interview, Mr Cummings stated that he had repeatedly advised Mr Hornby that the federal model of HBOS had run its course; and that he was frustrated with the profit targets which were set for him at Group level.

171. On 19 April 2010, Mr Walker prepared a briefing for the FSA's Board regarding the Project Rainbow investigations. He explained that Mr Cummings was likely to defend the case against him on the basis that, among other things, the Corporate Division's *"…strategy was endorsed by the Board"*. The paper also said that Enforcement had *"…recently informed Andy Hornby and Lord Stevenson that we will be interviewing them as part of this work. We are seeking to do this in late April/early May"*.

172. On 8 April 2010, the Financial Services Act 2010 entered into force, extending the limitation period (for bringing disciplinary proceedings) to three years with effect from two months after the commencement of the Act[34] i.e. from 8 June 2010. The FSA took the view that, in cases where the two year limitation period was yet to expire at the date when the new provision came into effect, it could rely on the new three year limitation period. On this basis, the FSA now had an extra year in the case of Mr Cummings i.e. until mid-June 2011.

173. In April 2010, Enforcement began drafting a PIR relating to Mr Cummings. A note produced by Enforcement (entitled '*Brief summary of the most significant further steps that might be taken in investigation in event that PIR can be served at end of July 2010 arising from brainstorming session on 28 April 2010')* stated that (emphasis added): *"…realistically, there was insufficient time available to seek to expand the putative case to include potential allegations of a breach relating to provisioning or a potential case against the group board."* It, therefore, appears that there was recognition that, even with the new three year time limit, any further enforcement action in relation to other Board members was now unrealistic.

174. On 11 May 2010, Mr Walker produced a document entitled *'Project Rainbow: update for the Board'* i.e. the FSA Board. With regard to the case against Mr Cummings, the document stated: *"Our preliminary view is that there is a case against Mr Cummings…This case will not be straightforward. Mr Cummings will state that…corporate growth strategy/risk appetite was endorsed by the Board"*. Under the heading '*Other Directors'*, the document stated: *"We have considered a case against Andy Hornby based on his failure to oversee the Corporate Division (his focus was on retail and he appeared to rely on informal updates from Mr Cummings). After careful consideration we have not put Mr Hornby under investigation because it is unlikely further work will*

(34) Clause 17 of the Financial Services Bill 2009 (introduced to Parliament in November 2009) proposed extending the limitation from two to four years. However, in about March 2010, Clause 17 was revised so as to extend the limitation period to three years. The FSA had asked the Treasury to increase the time limit because it needed more time to investigate some cases, particularly more complex cases and those involving senior individuals.

identify the necessary evidence. We have interviews scheduled at end May 2010 with Mr Hornby and Dennis Stevenson (ex-Chairman). We will reconsider our approach after these."

175. It, therefore, appears that Enforcement planned to reconsider whether or not to investigate Mr Hornby after his interview (despite the view that, even with the new three year time limit, any further enforcement action was unrealistic).

C

176. On 20 May 2010, the FSA conducted an interview with Lord Stevenson i.e. in the context of the investigation of Mr Cummings. He said that Mr Cummings had been "*…very concerned about risk management and very interested in it*". His view was that "*…at the end of the day the key challenge to someone working damn hard like Peter Cummings would be his executive boss and the people alongside him. In terms of non-executive and outside challenge, I would say the Corporate Risk Control Committee was the key forum… and the main Board*". Lord Stevenson stated that "*Bank of Scotland had always been over-exposed to property and we all worried about it a great deal*", but he then corrected that statement as follows: "*No, I didn't say "over-exposure" I said the "exposure"*.. He did, however, state that the "*minus*" of the federal structure was "*the lack of complete central control*".

177. On 28 May 2010, the FSA conducted an interview with Mr Hornby i.e. in the context of the investigation of Mr Cummings. Mr Hornby acknowledged that it was clear from the outset of the 2007 planning process that *"…within Corporate we were clearly overweight in commercial property and therefore – and that was not just the case in the UK, but also the case in our overseas businesses"*. He accepted that he was well aware of the bank's reliance on wholesale funding. He denied, however, that HBOS planned to or did speed up demands for growth from the Corporate Division. In relation to profit, Mr Hornby described the 2007 Corporate Division target of 22% as being *"…above the Group average"*, but said that this was for the good reason of making up for lack of growth in Australia (part of the International Division) and in the Retail Division. Mr Hornby said that he did not remember his alleged behaviour at the December 2008 provisioning meeting which had been described by Mr Livingston in such vivid terms (paragraph 162 above).

178. In his Report interview, Mr Jones accepted that in various respects Mr Hornby's answers in the FSA interview had been *"not satisfactory"*, but stated that *"you very rarely gain very much from interviews"*. He also said: *"…we did the interview with Hornby and… we formed the view that the possibilities of winning a case against Andy Hornby and the tribunal had become even more remote."*

179. The FSA continued to hold interviews in the investigation of Mr Cummings throughout the summer of 2010. There were further interviews with Mr Cummings on 7 and 8 September 2010, in which he made specific and repeated reference to high profit and asset growth targets having been set for 2006, 2007 and 2008 by Mr Crosby and Mr Hornby, which were significantly in excess of the figures which Mr Cummings had himself proposed.

180. On 21 September 2010, Enforcement produced an '*ExCo Summary Paper*', providing an update for ExCo on the Project Rainbow investigations. It stated (emphasis added): *"We have interviewed both Andy Hornby and Dennis Stevenson (ex-Chairman) and considered whether there is a case against them based on their failure to oversee the Corporate Division (Group's focus was on retail and Hornby appeared to rely on informal updates from Cummings). <u>After careful consideration we have not put either under investigation because it is unlikely further work will identify personable culpability</u>."* If, following the interviews of Mr Hornby and Lord Stevenson, "*careful consideration*" had been given as to whether or not to investigate them, that is not apparent from the existing documentary material. There is no material to show how, when or by whom such consideration was given. Indeed, this is the first document suggesting that there was any consideration of investigating Lord Stevenson, and there are certainly no documents recording who gave "*careful consideration*" to this issue, or when, or the factors that were taken into account in deciding not to investigate him.

181. On 19 October 2010, Enforcement produced a further '*ExCo Summary Paper*', again updating ExCo on the Project Rainbow investigations. In this paper, rather more information was provided as to the reasons for not investigating Mr Hornby.

> "*…We have considered a case against Andy Hornby based on his failure adequately to oversee the Corporate Division and to press Cummings to increase profits. Our analysis, including interviews with Hornby and the chairman in place at the relevant time, shows that while Hornby was from mid-2007 spending more time on the retail and treasury business (which he saw as higher risks), he had established systems to update him on the performance of corporate (a mix of high level MI and one to one meetings with Cummings), a governance framework including an appropriately established credit committee and a group risk function supported by NED involvement.*
>
> *…Our criticism of Corporate is that the MI did not accurately reflect the high risk of many of the very large loans, the strategy followed by corporate was too aggressive given known weaknesses in systems and controls and (possibly) that insufficiently timely steps were taken to improve the systems and controls from 2006. We allege that Cummings was primarily responsible for the above failures. While there may have been inadequacies in Hornby's role, we do not think these support a realistic enforcement case, not least because of the other matters at HBOS during the relevant period (i.e. deterioration of the residential property Market and funding problems) and Hornby's belief (not wholly unreasonable given the information he received) that risk in Corporate was reducing.*"

182. The process of drafting the PIR relating to Mr Cummings continued into early 2011. Towards the end of the drafting process (in around January 2011), the Enforcement investigation case team involved Ms Evans (a Manager in the Legal Group in Enforcement) to conduct the legal review of its preliminary findings. At a meeting on 11 January 2011 (attended by, among others, Mr Jones and Ms Evans) it was agreed that the case against Mr Cummings would be presented to the RDC on the basis of a breach of Statement of Principle 6 only (i.e. due skill, care and diligence).

183. On 1 February 2011 (after around ten months), Enforcement finalised the PIR, and served it on Mr Cummings on 3 February 2011 (with a Preliminary Findings Letter). It was 760 pages in length, excluding appendices and supporting documentation (which ran to around a further 50 lever arch files). The key allegations were that Mr Cummings had breached Statement of Principle 6, in that:

(a) Between 1 January 2006 and March 2008, Mr Cummings had *"permitted"* the Corporate Division to pursue an aggressive growth strategy despite known weaknesses in its operating model and market issues, without reasonably assessing or mitigating the risks involved; and

(b) Between April and December 2008, Mr Cummings had failed to take reasonable care to ensure that the Corporate Division adequately managed high value transactions which showed signs of stress.

184. On 9 February 2011, Ms Evans wrote a note to Mr Jones and others on '*Key vulnerabilities'* in the case against Mr Cummings, which included: *"Reliance on oversight of Group Risk"*; *"Reliance on oversight of Group Internal Audit"*; *"Reliance on oversight of Group senior management"*; *"Cummings was CF1 rather than CF3"* and *"Growth decisions driven by Group"*. It is clear from this summary that the FSA was aware that its case against Mr Cummings inevitably raised questions as to who was actually responsible for the risks which had been taken by the Corporate Division.

185. The position had, therefore, been reached by early February 2011 whereby Enforcement had completed its investigation of Mr Cummings; and a PIR had been drafted and provided to Mr Cummings, setting out the FSA's '*preliminary'* findings against him. Between January and March 2010, Enforcement had also considered the position of Mr Hornby, and had decided not

to investigate him; and there appears to have been a decision not to investigate Lord Stevenson, albeit it is entirely unclear who took this decision, when or for what reasons. No consideration had yet been given as to whether to investigate any other former senior managers of the failed bank, or the bank itself.

C.5 The decision to investigate BoS; and the ongoing action against Mr Cummings: February 2011 to May 2011

186. From early 2011, the FSA began to consider whether or not to bring enforcement action against the failed bank i.e. HBOS/BoS (which was referred to by the FSA, and is referred to below, as 'the firm')(35). As set out below, the genesis of this consideration was a concern, raised by Ms Evans (a Manager in the Legal Group in Enforcement) as part of the legal review of the case against Mr Cummings, that the case as then formulated against Mr Cummings had a potential legal weakness. By the time the FSA began its consideration of enforcement action against the firm, Lloyds Banking Group had been co-operating with the FSA's investigation of Mr Cummings for almost two years and, during that time, there had been no suggestion that the firm might itself be the subject of investigation. The FSA's consideration of an investigation into the firm only related to its conduct in relation to the Corporate Division.

187. On 9 February 2011, Ms Evans sent to Mr Jones a draft memorandum entitled '*Draft memo re proceeding against the firm 20110208*'. The introductory section stated (original emphasis):

> *"The investigation to date has only considered the conduct of Mr Cummings and has not extended to the firm. [**explain why not**]. The Legal Review Team have suggested that this point be re-opened as they consider there to be significant advantage in extending the investigation to the firm and seeking to impose a penalty at the corporate level in addition to the proposed action against Mr Cummings personally.*
>
> *The pros and cons of this approach are discussed in more detail below.*
>
> *It is considered that taking action against the firm increases the likelihood of securing a public outcome against at least one culpable party, and that the desirability of achieving this outweighs the disadvantages discussed below. We recommend that the investigation (and subsequent enforcement action) be extended to the firm."*

188. The '*Conclusion*' in the draft memorandum was that it was "*highly desirable*" to extend enforcement action to '*the firm*'. This was because there was a "*real risk*" that the case against Mr Cummings would fail before the RDC, whereas there was a greater likelihood of success in any action against the firm; and that, if the FSA was to bring enforcement proceedings against both Mr Cummings and the firm, "*the chances of securing a public outcome against at least one defendant would be significantly improved.*" Furthermore, by including an allegation that Mr Cummings was '*knowingly concerned*' in a breach by the firm, the prospect of succeeding against Mr Cummings would also be improved.

189. When asked in her Report interview what had prompted the production of this draft memorandum, Ms Evans said: *"One of the issues we had in relation to Mr Cummings was whether we could rely purely on APER as a basis for the case…because we had a concern that Mr Cummings' lawyers might seek to raise quite a technical argument about the fact that corporate lending isn't strictly a regulated activity…And, therefore our normal strategy in circumstances like that is to examine whether as an alternative we can bring a "knowingly concerned" case, i.e. Mr Cummings was knowingly concerned in a breach of regulatory requirement by the firm. And we decided that*

(35) As explained in footnote 2 above, enforcement action was brought against BoS as the business of the Corporate Division was conducted through BoS.

that would be a sensible thing to do to cut off that possible avenue of legal argument." Therefore, as Ms Evans accepted, the *"genesis"* of the idea of pursuing the firm was a desire to meet a possible technical argument by Mr Cummings in the disciplinary proceedings against him; albeit that the idea then broadened out into a way of being *"able to tell the story"* in the event that the case against Mr Cummings failed.

190. Later the same day, Mr Jones sent an email to Ms Evans objecting to the suggestion of pursuing the firm ("*I disagree with your recommendation*"). He stated that the FSA had decided to pursue Mr Cummings and not the firm in 2009 because this was *"…part of a group of cases (Project Rainbow) aiming to put across a message about personal accountability in order to change industry perceptions"*. His principal objections were a risk to the timetable for the investigation of Mr Cummings, and lack of resources. When asked about this in his Report interview, Mr Jones said that he was concerned that a legal challenge might be launched by Lloyds Banking Group (i.e. because it had previously co-operated in the investigation without ever being told that the firm might itself become a subject of investigation); and that this would be a huge distraction from which little would be gained.

191. On 15 February 2011, Ms Evans and Mr Jones produced a more detailed paper for Ms Cole and Mr Walker dealing with the advantages and disadvantages of extending the scope of the investigation (1) to add a '*knowingly concerned*' allegation against Mr Cummings, and (2) to pursue the firm. The paper recommended adding a '*knowingly concerned*' allegation, but made no recommendation as to whether to investigate the firm (presumably because of Mr Jones's reluctance to start such an investigation).

192. The paper suggested that a decision had been taken at the referral stage not to investigate the firm: *"Although it was recognised that there was likely to be a strong case against the firm, the decision was taken that it was more important to send a clear message in relation to the personal culpability of senior management."* In fact, as made clear above (section C(1)), no consideration appears to have taken place within the FSA in the period leading up to 26 February 2009 as to whether or not to investigate the firm (although the issue had been raised in the emails referred to in paragraphs 72 and 74 above); and there does not appear to have been any discussion or recognition in that period as to whether there was likely to be a "*strong case against the firm*". Ms Evans and Mr Jones were not involved in the decision-making process in the period up to 26 February 2009, and appear to have assumed, understandably, that proper consideration must have been given to an investigation of the firm and that a decision had been made not to investigate it.

193. The paper stated that there "*is a real risk that the RDC may decide not to issue a Decision Notice to Mr Cummings*"; that "*we are actively considering the steps that we can take to strengthen our position further*"; that "*one such step is to plead in the Warning Notice in the alternative an allegation that Mr Cummings was knowingly concerned in a breach by the firm, Bank of Scotland plc, of Principle 3"*. The prospect of running that argument *"…raises the question of whether we should also start a separate investigation into Bank of Scotland plc in respect of its underlying breach (and if so when)"*. Such a course would involve *"…a significant change in our approach to the case, made at the late stages of a long running investigation"*, but the *"…chances of success are greater than in relation to Mr Cummings alone."*

194. The paper also identified a further advantage of pursuing the firm in that such a step (emphasis added) "*…will help to demonstrate that we are not treating Mr Cummings as a scapegoat for corporate misconduct, which should strengthen our overall position against him before the RDC. This is because the Legal Review Team have advised that the RDC will find it more attractive to hold Mr Cummings to account…if they know we are also seeking disciplinary action against the firm which makes it clear there were serious failings within HBOS at Group level as well.*"

195. Ms Evans was clear in her Report interview that this process of considering an investigation into the firm had not included any reconsideration of individuals such as Mr Hornby. As she put it: "*This is not a point in time at which we were thinking we should be investigating Hornby. That just wasn't happening.*" Ms Evans did, however, make clear that, as a Manager in the Legal Group in Enforcement, she considered it to be "*…an absolute no-brainer that there was a breach by the firm*", because "*[a]ll the breaches by Mr Cummings were, in effect, attributable to the firm*". Her view was that the case against the firm was more straightforward than the case against Mr Cummings.

196. On 17 February 2011, a meeting was attended by, among others, Ms Cole, Mr Walker, Mr Jones, and Ms Evans. The note of that meeting records that *"…after discussing the issues raised in the memo, MC acknowledged the complex considerations involved. She stated that she would need to discuss these issues with Hector Sants before making a decision"*. When asked in her Report interview what the *"issues"* had been, Ms Cole clarified that the concerns arose from the fact that Lloyds Banking Group had already offered substantial co-operation in the investigation of Mr Cummings, and that enforcement action against the firm might (in the light of the allegations that would be made) result in potential lawsuits.

197. On 18 February 2011, Ms Cole sent an email to Mr Walker recording her discussion with Sir Hector Sants. She stated that Sir Hector wanted to defer the decision to April; and he wanted a legal opinion for ExCo on the *"…properness of our appointing investigators to the firm with a view to a notice being published designed to tell the story"*. Mr Walker replied: *"I assume you are now content for us to expand the scope of the cummings investigation to knowingly concerned in a breach by the firm. This helps our case against him…If the firm queries this we will tell them that the expansion is about the cummings case. If pressed we will say we stick to the line that we have no current intention of investigating the firm but will keep this under review as we do in all cases"*, to which Ms Cole replied *"yes fine"*.

198. In their Report interviews, both Ms Cole and Mr Walker maintained that what they were proposing to tell Lloyds Banking Group if asked (i.e. that *"we have no current intention of investigating the firm but will keep this under review as we do in all cases"*) was true because, although the FSA was engaged in a process of deciding whether to investigate the firm, a decision had been deferred until April 2011 so that there was no *"current intention"* to investigate.

199. On 23 February 2011, a '*Notice of Change of Scope of Investigation*' was sent to Mr Cummings, which stated that he was '*knowingly concerned*' with a contravention of Principle 3 by the firm.

200. On 4 March 2011, the Legal Group in Enforcement sent an email to Mr Jones and others, attaching a 36 page note entitled '*Penalty Analysis for Peter Cummings*'. The note recommended a penalty of £500,000 to £750,000, but said that the *"…risk in pursuing a penalty at the upper end of this range or above is that we would (on objective criteria) be seen as treating Mr Cummings as a scapegoat"*; and that *"[w]e could be perceived as seeking to impose a penalty for wrongdoing that should be visited on HBOS rather than the individual"*.

201. On 7 March 2011, Ms Evans, having been asked to produce the legal opinion required by Sir Hector Sants for ExCo on the *"…properness of our appointing investigators to the firm with a view to a notice being published designed to tell the story"*, sent an email to Mr Jones and Mr Walker, entitled '*Havana: note for Exco*'. This email raised the issue as to whether there was any record of why the FSA had not already started an investigation of the firm:

(a) Ms Evans' email (at 8:06am) stated (emphasis added): *"I am about to start on this, and there is one point on which I will need some help. I need to bottom out exactly how and why it was decided, in relation to the Project Rainbow cases, that these should focus on senior managers rather than the firms. I have the Havana ERD, but this does not deal with the issue. Is there a*

high level scoping document for all the Project Rainbow cases which discusses the proposed approach? This is an important point as I will need to track through the basis of our decision-making. Please could you give some thought to where and how this has been recorded."

(b) Mr Jones was the first to reply (at 8:10am), copying in Mr Wilson (the Manager in Enforcement responsible for the enforcement investigation relating to RBS) and another Manager in Enforcement: *"I don't have, and don't remember any global documents. Mr Wilson or Sam might?"*

(c) Mr Wilson replied shortly thereafter (at 8:17am): *"I haven't seen any."*

(d) Mr Walker then replied (at 8:58am) (emphasis added): *"We followed the normal decision making process so the decision is recorded in the ERD. There were discussions as usual with supervisors ahead of the ERD being produced and it was through this process that the scope of the investigation was arrived at. As in Northern Rock we saw these cases as about senior management failures (rather than a corporate failure) and the scope of the investigation reflected this."*

202. Mr Walker's statement did not address the issue raised by Ms Evans. The ERD relating to Mr Cummings (attached at annexe 4 to this Report) did not contain any information as to *"how and why it was decided, in relation to the Project Rainbow cases, that these should focus on senior managers rather than the firms"* (this being the issue raised by Ms Evans). The ERD contained no information relating to any decision not to investigate the firm. In his Report interview, Mr Walker accepted that an ERD does not record "*what's not in the scope"* (i.e. what is not within the scope of the investigation).

203. The correct answer to Ms Evans' question was that there was no document in which the FSA recorded "*…how and why it was decided, in relation to the Project Rainbow cases, that these should focus on senior managers rather than the firms"*. There had never been any proper consideration by the FSA of investigating the firm, or indeed anyone other than Mr Cummings, during the decision-making process in the period from early December 2008 to 26 February 2009.

204. On 10 March 2011, Ms Evans produced a first draft Warning Notice for Mr Cummings. It proposed a penalty of £750,000 for breach of Statement of Principle 6 and for being '*knowingly concerned*' in the firm's breach of Principle 3. This draft was recirculated on 30 March 2011 (following a meeting between the Enforcement case team and Ms Evans, the legal reviewer, on 14 March at which there was a detailed discussion as to the size of penalty), by which time the suggested penalty had risen to a range from £850,000 to £1 million. These drafts of the Warning Notice did not seek any prohibition order.

205. On 1 April 2011, Ms McDermott took over from Ms Cole as Director of Enforcement. She quickly formed the view that an investigation of the firm was appropriate, stating in her Report interview that: "*…as soon as this was discussed with me, when I took over on 1st April, whether we should extend the investigation, it seemed to me that we should. It seemed to me to be an obvious thing that we should take action against the firm as well as the individual, given the risks and dangers in the individual action and given the possibility of taking out the story.*"

206. On 5 April 2011, Ms Evans produced a further draft Warning Notice. Her covering email to Mr Jones referred to the draft Warning Notice as being "*revised to reflect my discussions with Mr Walker on Monday*". The draft now sought a £1 million penalty and a prohibition order.

207. On 7 April 2011, Mr Walker, as Project Sponsor, and Ms Evans (as legal reviewer) signed an Enforcement Submissions Document ('ESD') (paragraph 51 above) recommending that the RDC consider taking enforcement action against Mr Cummings as set out in an attached draft Warning Notice. The recommendation made in the ESD was that the RDC issue a Warning

Notice to Mr Cummings which proposed the imposition of a £1 million penalty and a prohibition order. That day, Enforcement sent to the RDC the following documents: the ESD, a draft Warning Notice, and the PIR. The ESD stated that: "*The investigation into Mr Cummings is the largest investigation the FSA has to date conducted in respect of the failings of an individual.*"

C

208. On 12 April 2011, there was an oral presentation made by Enforcement to the RDC, following which a further draft Warning Notice was circulated on 13 April 2011.

209. On 14 April 2011, an '*ExCo Summary Paper*' was produced by Ms Evans for ExCo, entitled '*Project Havana: Extending the Scope of the Investigation to the Firm*'. The paper noted: *"Although the matter was originally referred to Enforcement as a senior management matter, it is considered that the investigation also indicates clear regulatory breaches on the part of HBOS (now part of Lloyds Banking Group). As a consequence, it is recommended that consideration be given to investigating and proceeding against the firm."* The paper noted the "*high degree of legal risk*" in the case against Mr Cummings, which "*means that there is a real risk that a public outcome will not be achieved whereby the "HBOS story" can be told*".

210. The paper also recorded (emphasis added) that the FSA had "*…made a positive decision at the time of referral to Enforcement not to investigate the firm, despite being aware at the time of the referral that it was likely that the firm had breached regulatory requirements*" in the form of systems and control weaknesses; that the decision "*…reflected our focus on senior management which is part of the FSA's wider strategy regarding the accountability of senior management*"; and that the decision was "*…a means of keeping a substantial and complex investigation tightly focussed*". Ms Evans has stated that the reference to a "*positive decision*" may have been based on information provided to her orally at around this time. As set out above, there is no evidence of any such "*positive decision*" at the time of Mr Cummings' referral, and indeed it appears that enforcement action against the firm was not then seriously considered. For that reason, Mr Adamson (Supervision, and a member of ExCo) accepted in his Report interview that this '*ExCo Summary Paper*' was "*not quite correct*". Ms McDermott said, in her Report interview, that what had changed (i.e. between February 2009 and April 2011 so as to justify bringing in the firm at this late stage) was the view of the legal reviewer (Ms Evans); and she also referred to the fact that, following the conclusion of the RBS investigation, there had been media and parliamentary comment as to "*why on earth wasn't there action taken against RBS*". Ms Evans and Mr Walker each expressed the view in their Report interviews that there was now, as a result of the investigation of Mr Cummings, an improved understanding of the matters justifying enforcement action against the firm.

211. The paper also attached an Annex which provided "*…for information, a brief summary of our analysis of the merits of proceedings with a listings case against the firm*". The Annex recommended that no action should be brought under the Prospectus and Listing Rules in respect of the various public disclosures made by HBOS Group in 2008, because (1) any allegation that the level of impairment had been understated would "*…rely on showing that this was material to the financial position of the Group as a whole*"; (2) it was thought unlikely that a breach could be demonstrated given sign-off by KPMG, other advisors and the Audit Committee, and the knowledge of the FSA; (3) the fact that the disclosures had "*included warnings in respect of HBOS Corporate's loan book*"; and (4) it was highly likely that any proceedings were already time-barred. The authors of the paper stated that they had included the Annex so as to explain why they were "*confident*" that any "*…criticism, for example from the Lloyds Action Now Group, that the FSA has not taken action in respect of alleged mis-statements in prospectuses*" would "*not be well founded*".

212. On 14 April 2011, ExCo accepted the recommendation that the firm should be referred to Enforcement. The FSA decided to delay informing Lloyds Banking Group of the decision to expand the scope of the investigation to include the firm while it considered whether it would be seeking a penalty against the firm. Mr Walker was informed of this decision on 17 April 2011. He

stated in his Report interview that it was *"quite unusual"* for ExCo to have been involved in endorsing a referral to Enforcement in this way.

213. On 10 May 2011, Mr Walker, Mr Jones and Ms Evans sent a paper to Ms McDermott and Andrew Bailey (Director, in Supervision) entitled '*Project Havana: Extension of the scope of the investigation to Bank of Scotland Plc'*. It stated that: *"…the purpose of this note is to advise you of the approach we propose to take when advising the Firm of the extension in scope."* It further stated: *"We propose to explain to the firm that:…a decision has been made to extend the scope of the investigation on the basis that we have now reached a stage in our investigation of Peter Cummings at which it appears to us that there may also have been serious regulatory breaches on the part of the Firm such that it could be appropriate and proportionate to take formal enforcement action. The investigation into Mr Cummings is substantially complete…As a consequence we now have a far clearer understanding of the way in which events unfolded during the relevant period. Accordingly, the FSA has taken stock of the position and reassessed whether the scope of the original investigation remained appropriate and concluded that it did not…no further extensions in scope (eg to other members of the Firm's senior management team) are under consideration."*

214. By mid-May 2011, Enforcement had decided, in principle, that it would not be appropriate to impose a financial penalty on the firm and that there should be a public censure.

215. On 24 May 2011, the FSA informed Lloyds Banking Group that it had decided to place BoS under investigation in respect of the issues uncovered in the investigation of Mr Cummings. The minutes of that call indicate that Mr Walker informed Lloyds Banking Group that no work was being done on any wider investigation, and *"…there was no current intention to change this position"*; and that there was *"…no current intention to place any other individuals under investigation in respect of the matters uncovered in the PC investigation"*.

216. On 27 May 2011, the FSA, by its MAI, formally appointed investigators under section 168 of the Act. The MAI stated that there were circumstances suggesting that BoS may have contravened Principle 3 in the management of the Corporate Division during the period 1 January 2006 to 16 January 2009.

217. It is, therefore, apparent that, in the period from early February 2011 to the end of May 2011, the FSA came to open an investigation of BoS in the following way:

(a) The legal reviewer of the case against Mr Cummings identified a potential weakness in the case against Mr Cummings.

(b) With a view to eliminating that weakness, she proposed expanding the case against Mr Cummings to include an allegation that he had been '*knowingly concerned*' in a breach by the firm.

(c) In considering the case against Mr Cummings, the question arose as to whether an investigation of the firm itself should be conducted, a question which was ultimately resolved in the affirmative by ExCo, on the recommendation of the new Director of Enforcement, Ms McDermott.

(d) One of the perceived advantages of bringing the case against the firm was that, if the case against Mr Cummings did not succeed (as was considered a real possibility), part of the "*HBOS story*" (that relating to the Corporate Division) would at least be told thereby obtaining a "*public outcome*" (assuming the case against the firm was successful). A further perceived advantage was that it would help show to the RDC that the FSA was not treating Mr Cummings as a scapegoat for corporate misconduct.

218. Given that, unusually, ExCo (rather than Supervision and Enforcement) had made the decision to investigate BoS, no ERD was issued.

C.6 Warning Notice, Decision Notice, Final Notice & compromise: June 2011 to September 2012

219. On 3 June 2011, the RDC issued a Warning Notice to Mr Cummings. The '*Proposed Action*' was (1) a financial penalty of £1 million on the grounds that he had failed to comply with Statement of Principle 6 and was '*knowingly concerned*' in a contravention by BoS of Principle 3, and (2) a prohibition order. The '*Summary*' identified the central allegation, in the period prior to March 2008, as being that Mr Cummings had *"directed"* aggressive growth targets for the Corporate Division, despite known weaknesses in the control framework and worsening market conditions.

220. On 8 June 2011, the FSA held a scoping meeting with Lloyds Banking Group. According to a note of the meeting, the FSA explained that, in addition to covering the issues arising in the investigation of Mr Cummings, the investigation would also cover, among other things, *"…potential failings at Group level in the firm's 2nd and 3rd lines of defence (in particular around Group Risk and Group Internal Audit)"* and incentives for Corporate Division staff. Lloyds Banking Group asked whether the FSA *"…may also be looking at other individuals on the HBOS Board"* and the FSA confirmed that it had no current intention to do so and that there would likely be limitation issues in relation to any such investigation.

221. On 30 June 2011, the FSA's ExCo met and discussed, among other things, resources for investigations by Enforcement. The minutes of that meeting record that the committee agreed *"…if Enforcement was presented with a case of substance that it was unable to resource an investigation on, it should bring the case outline to ExCo for consideration. If appropriate, ExCo would escalate the issue to the Board for additional resource approval"*. Indeed, it was made clear by a number of Report interviewees (including Sir Hector Sants, Ms Cole and Ms McDermott) that, if Enforcement had wanted to conduct broader investigations than those in fact conducted in relation to the failure of HBOS, finance would have been made available. Ms McDermott added that further resourcing would have been considered in the light of whether "*there is a sensible case that's likely to produce an outcome*".

222. On 28 July 2011, Enforcement produced a draft Warning Notice relating to BoS, together with a PIR and a Supplemental Enforcement Submissions Document (the 'SESD') for submission to the RDC. The SESD made clear that the enforcement action related to the conduct of BoS "*…in the management and control of its Corporate Division…*"; and that "*…to a large extent, the case against the Firm is based on Mr Cummings' conduct. However, there were also issues with the oversight and control of the Corporate Division by the Firm's group control functions. The failings, at both divisional and group level, warrant a separate public regulatory outcome against the Firm*". Enforcement's recommendation was that the RDC issue a Warning Notice that proposed the issue of a public censure for breach of Principle 3. No financial penalty was recommended. In his Report interview, Mr Walker confirmed that, by the time these documents were produced, there had been *"very little investigation"* of BoS in addition to that performed in the investigation of Mr Cummings; and that, in fact, there *"may not have been any"* additional investigation.

223. On 3 August 2011, the legal adviser to the RDC informed Enforcement of the RDC's initial view. An internal email recorded the communication as follows: "*He indicated that the RDC's current feelings on BoS were that all members felt they would struggle to issue a WN that did not include a financial penalty…he went on to say, that 'just because tax payers money had been injected into the company did not mean the FSA should not fine the business £50m, such a fine would serve to reduce the money available for bonuses'. [The legal adviser] ended by saying that the RDC might be persuaded not to adopt such a course by well-rehearsed arguments.*"

224. Following the concern raised by the RDC, Enforcement gave further consideration to the issue as to whether or not a financial penalty was appropriate. A note was produced by Enforcement on 10 August 2011 entitled '*Financial penalty v Public censure*'. The note stated that a £100 million penalty would be justified but questioned whether it would be appropriate in circumstances where Lloyds Banking Group had rescued HBOS with UK Government support, had already suffered multi-Billion pound losses, there had been significant change in the bank's management and ownership, and the value of an indicative penalty was questionable given the fact that the FSA now had a new penalties regime. The note also recorded that early indications had been given to Lloyds Banking Group by Enforcement that the likely outcome was a public censure and that it might create legal risk if the FSA now sought to impose a penalty.

225. In mid-August, Enforcement decided that it would inform the RDC that its strong view was that there should not be a financial penalty. A note was sent to the RDC on 22 August 2011 explaining the exceptional circumstances which Enforcement considered merited only public censure in this case. These were as follows:

(a) Any penalty would ultimately be paid by Lloyds Banking Group which was not connected with, or at the time of the merger aware of, the serious misconduct which had been committed by BoS.

(b) The circumstances in which Lloyds Banking Group acquired HBOS with substantial government support were unprecedented. Without the acquisition, HBOS would have become insolvent.

(c) A by-product of the acquisition of HBOS by Lloyds Banking Group was to stabilise the UK's banking system at a time of crisis, with resulting consumer and Market confidence benefits.

(d) Lloyds Banking Group was 41% publicly owned, at a net cost of £17.4 Billion to UK taxpayers.

(e) Lloyds Banking Group and its shareholders had already suffered significant losses as a result of the acquisition of HBOS.

(f) Credible deterrence could be achieved through public censure in a notice that detailed the serious failings of BoS and gave a stark message about the overwhelming losses suffered as a result of those failings.

226. On 26 August 2011, Enforcement produced a further memo which set out its recommendation in the event that "*the RDC considers that the Warning Notice should spell out the justification for the public censure by referring to more than simply the "exceptional circumstances of this case"*. The recommendation was that the Warning Notice should explain that: *"The very serious nature of the breaches identified in this Notice would have led the FSA to impose a substantial financial penalty were it not for the fact that the penalty would, in effect, be paid by [Lloyds Banking Group] and the exceptional circumstances in which [Lloyds Banking Group] acquired the firm. One effect of the acquisition was to help stabilise the UK's banking system at a time of crisis, which was in the public interest."* Further possible formulations for the RDC to adopt were suggested in a memo of 2 September 2011.

227. On 22 September 2011, the RDC issued a Warning Notice to BoS. The '*Proposed Action*' was that the FSA proposed to publish a statement to the effect that BoS had failed to comply with Principle 3; that a very substantial financial penalty would have been merited; but that "*in the exceptional circumstances of this case*", the FSA did not intend to impose one. The reason given for not imposing a penalty was that public funds had already been expended in order to deal with the consequences of the misconduct for which a penalty would have been imposed, and that "*the taxpayer would again be impacted by any such financial penalty*". The Warning Notice

related to BoS's conduct in relation to the Corporate Division. It repeatedly described the misconduct of BoS as *"very serious"*.

228. On 7 November 2011, Mr Cummings submitted his written representations to the RDC in response to the Warning Notice which had been issued to him in June 2011 (paragraph 219 above). In those representations, Mr Cummings disputed that he had *"directed"* the growth strategy and instead submitted that the strategy had been settled by the Board. He argued that others must have been *"at least equally responsible"* and that there was *"no proper evidential basis"* for imputing personal responsibility to him for all of the difficulties which HBOS had experienced. He emphasised the corporate nature of decision-making at HBOS; and that the pace of growth within the Corporate Division had been driven by Mr Hornby (former Group CEO) and Mr Hodkinson (former Group Finance Director), neither of whom were facing disciplinary action by the FSA.

229. On 12 December 2011, BoS submitted its written representations to the RDC in response to the Warning Notice which had been issued to it in September 2011 (paragraph 227 above). By this point, the FSA was accordingly presented for the first time with the full range of submissions which would be advanced by Mr Cummings and BoS at the eventual RDC meeting.

230. On 29 February 2012, Enforcement served a joint response to the written representations of Mr Cummings and BoS. In response to Mr Cummings' emphasis on the role of others in setting growth targets, Enforcement argued that Mr Cummings had had a unique understanding of how risky the targets were, and yet had failed to tell the Board how risky it would be to implement the agreed strategy.

231. In early March 2012, Enforcement began preparing for the oral representations hearing before the RDC. Ms Evans asked the Enforcement investigation case team to provide comments on "*Reasons no action against Hornby*" i.e. why had the FSA decided not to bring enforcement action against Mr Hornby. On 7 March 2012, a member of Enforcement's Legal Group sent Ms Evans an email, identifying the following factors:

> *"1. [Mr Hornby had] [l]ittle corporate experience, placed reliance on Cummings …*
>
> *2. He [Mr Hornby] was responsible for six (he says 7 or 8?) different Divisions cannot therefore have had the level of understanding of each Division as that Division's CEO" …*
>
> *3. He had no knowledge of individual deals in contrast to Cummings …*
>
> *4. He had no knowledge of problems with credit sanctioning in contrast to Cummings …*
>
> *5. He was unaware of specifics of Corporate's strategy in the way Cummings would have …*
>
> *6. He was unaware Corporate was adopting a lending through the cycle strategy."*

232. These were reasons which the FSA intended to present to the RDC if asked at the hearing as to why it was appropriate not to have investigated Mr Hornby i.e. they were an ex post facto justification, and were not intended to be an explanation of any decision-making process in the period up to 26 February 2009. In her Report interview, Ms Evans stated that, by this point, the FSA was *"…perfectly comfortable with the fact that Mr Hornby was not personally culpable for the failings in Corporate"*.

233. On 7 March 2012, the FSA settled its enforcement action against BoS. A Final Notice in relation to the settlement was published on 9 March 2012, publicly censuring BoS for the *"very serious misconduct of the Firm"*.

234. On 8 March 2012, the oral representations hearing in relation to the proceedings against Mr Cummings took place before the RDC. In oral submissions made on behalf of Mr Cummings, Leading Counsel clearly laid blame at the doors of HBOS Group and Mr Hornby in respect of the *"direction"* of the strategy for the Corporate Division. Although Leading Counsel accepted that the RDC had to apply the facts before it to the legal tests (i.e. the tests for establishing misconduct and/or lack of fitness and propriety), he argued that, because Mr Cummings had been selected at an early stage as the only person for investigation, Enforcement had tailored its view of the facts to fit the desired outcome i.e. to get home against at least one individual now there was no-one else to focus fire on. Ms Evans, by contrast, argued that the Board had delegated to Mr Cummings specific responsibility for the strategy, performance, control, risk management and daily operation of the Corporate Division; that, although he was aware that the control environment was flawed, he continued to sanction high risk deals; that it was incumbent upon Mr Cummings to have *"challenged"* the increases in profit targets put forward to him by Group more robustly than he in fact did; and that he provided reassurance rather than warnings. She also argued that Mr Hornby had no individual responsibility for risk management.

235. On 22 May 2012, the RDC issued a Decision Notice to Mr Cummings. It imposed a financial penalty of £800,000, reduced from the £1 million in the Warning Notice. It also imposed a prohibition order which prohibited Mr Cummings from performing any significant influence function in any authorised firm that was a bank, building society, BIPRU investment firm or insurer "*on the grounds that he lacks competence and capability to perform such functions*".

236. In response to the Decision Notice, Mr Cummings' legal representatives (Stephenson Harwood) wrote to the FSA to inform it that Mr Cummings intended to commence judicial review proceedings on the ground that the RDC had failed to comply with its duty to provide sufficient reasons for its decision, in particular that the RDC had failed to provide sufficient reasons for imposing a penalty of £800,000.

237. While the FSA considered how best to respond to the threat of judicial review proceedings, discussions started between the FSA and Mr Cummings' legal representatives regarding the possibility of compromising the enforcement action on a '*no admissions*' basis, i.e. that Mr Cummings would agree to pay a reduced financial penalty and in return agree not to appeal to the Upper Tribunal. The RDC, in response to the threatened judicial review proceedings, decided to withdraw the Decision Notice and issue a replacement. However, as described below, in the meantime Mr Cummings agreed compromise terms with the FSA, and therefore the RDC did not issue a replacement Decision Notice.

238. On 23 July 2012, Enforcement prepared a Settlement Recommendation Document ('SRD') for Mr Cummings' case. The SRD was approved by Mr Adamson (Supervision) and Ms McDermott (Enforcement). It recommended that Enforcement be authorised to agree a financial penalty of between £500,000 and £600,000. The SRD explained:

> *"[The FSA] have pursued this case because of the significant public interest in ensuring that, particularly in relation to the financial crisis, the regulator is holding individuals to account where that is possible, and the FSA's commitment to taking robust enforcement action against senior management at large firms in appropriate cases where we can establish personal culpability. While the [proposed] financial penalty [on Mr Cummings] is reduced from that previously proposed it remains a significant amount for competence failings particularly taken together with prohibition. We are confident that, in all the circumstances of this case, by imposing a penalty on Mr Cummings within the proposed range, and prohibiting him from holding a significant influence function at any systemically important firm in the future, we will achieve this objective."*

239. The SRD set out the *"key impacts of not concluding a settlement"*, including the fact that, absent an agreed settlement, Mr Cummings was likely to appeal to the Upper Tribunal and that this

would delay the publication of any Decision Notice because the FSA anticipated that Mr Cummings would challenge any decision to publish the Decision Notice (although the FSA was confident that it could oppose a challenge to a decision to publish the Decision Notice). Enforcement also raised the fact that any final determination from the Upper Tribunal regarding a Final Notice would not be released until about June 2014, and that continuing proceedings against Mr Cummings would have implications on the publication of any report into why HBOS failed (by this time, the FSA had agreed with the Treasury Select Committee that it would produce such a report; paragraph 243 below).

240. The SRD further explained that Mr Cummings was insistent that he had not done anything wrong and therefore wanted to settle without making any admissions. The document explained that it was *"Enforcement's policy and practice not to agree 'no admissions' settlements other than in exceptional circumstances. However, our standard settlement procedure does not actually require subjects to expressly make admissions: it simply requires them not to contest the contents of their notices"*.

241. On 7 August 2012, there was an FSA Board meeting by telephone to discuss the developments regarding the firm and Mr Cummings. In an email dated 6 August 2012, James Strachan (an FSA Board member) expressed some dissatisfaction with the proposed settlement parameters: *"Regardless of the issue of whether the Board has the formal right to question or even overrule a proposed fine or penalty, would it please be possible for us to see a summary explanation of the proposed settlement figure…It may well be that there are good reasons or unwanted constraints that lie behind the number but, prima facie, it is a risibly small amount and seems out of line with our policy of credible deterrence."* In response to these concerns, Ms McDermott explained the reasons for the level of the financial penalty and expressed the view of the Settlement Decision Makers that *"in messaging and deterrence terms the penalty of 500k was still a significant one particularly taken together with the prohibition"*.

242. On 3 September 2012, Mr Cummings reached agreement with the FSA. He thereby agreed to the FSA issuing a Decision Notice, and thereafter a Final Notice, which imposed on him a financial penalty of £500,000 and a prohibition order. On 12 September 2012, the FSA published the Final Notice in relation to Mr Cummings.

C.7 The FSA's consideration of starting work on an HBOS report, and its consideration of investigating '*other individuals*': January to June 2012

243. On 6 January 2012, Lord Turner had sent an email to Sir Hector Sants ahead of an appearance by Lord Turner before the Treasury Select Committee. Lord Turner had previously assured the Treasury Select Committee that the FSA would produce a report into the failure of HBOS (an 'HBOS report') (just as one had been produced in relation to RBS), and wanted to discuss with Sir Hector Sants what should be said to the Treasury Select Committee about this proposed report (which he referred to as a "*drains up*" process). The email asked for guidance on what could be done without prejudging the existing enforcement actions. Sir Hector Sants forwarded the email to Ms McDermott (among others) so as to obtain Enforcement's view on the matter.

244. On 9 January 2012, this email was forwarded to Mr Walker by Ms McDermott. Ms McDermott informed Mr Walker that she had told ExCo that she had *"…serious concerns about us saying anything publicly about "starting" a report prior to the conclusion of the RDC process and to doing anything which might cut across the HBOS enforcement action"*. In her Report interview, Ms McDermott stated that the *"serious concerns"* she had at this time related to the difficulties of attempting to conduct ongoing enforcement cases in parallel with work on a wider HBOS report.

245. On 12 January 2012, Enforcement produced a paper for Sir Hector Sants and Lord Turner entitled '*Report on why HBOS failed: impact on enforcement work*'. The paper set out Enforcement's view of the risks of starting work, at that time, on a report into why HBOS failed. It stated: "*The enforcement preference would be for no work at all to be started on such a report until the enforcement cases have concluded.*" The paper identified a number of risks of conducting such parallel activities, including the fact that the work to be conducted in relation to an HBOS report might undermine the enforcement actions against Mr Cummings and BoS. The reasons for this included the fact that the additional information obtained in working on the report might lead "*to a conflict of evidence with the enforcement evidence*"; that such evidence would need to be disclosed to the subjects of the enforcement action; and that any "*discrepancies (be they real or immaterial) between evidence will be used by the defence to seek to undermine the enforcement case*".

246. On 16 February 2012, Enforcement produced a paper for Lord Turner entitled '*HBOS enforcement cases and publicity*'. The paper set out the '*current status*' of the enforcement actions against Mr Cummings and BoS, and also addressed what the FSA could say to the Treasury Select Committee about these actions and also the proposed report into the failure of HBOS. It included a section headed '*No enforcement action against others*' which stated: *"There is likely to be media and Treasury Select Committee interest in our reasons for not taking enforcement action against any other individuals on the HBOS board, in particular…James Crosby… and Andy Hornby…"*.

(a) In relation to Mr Crosby, it stated: *"Given that James Crosby left HBOS in July 2006, his conduct was not included in the scope of our work and no evidence came to light in our investigations to make us reassess this."*

(b) In relation to Mr Hornby, it stated: *"Andy Hornby's conduct was also not in the scope of our work. However, we kept this under review. In Q1 we asked Ernst & Young to assess the evidence they had gathered relating to Andy Hornby. We considered at that stage the merits of starting an enforcement investigation into potential failings in his oversight of Mr Cummings and the Corporate Division. However, we concluded that establishing personal culpability would be difficult given the key roles at Group level also played by HBOS's Group Risk and Finance Directors and the firm's federal structure. The decision was therefore taken not to investigate Andy Hornby, although we did interview him for the purposes of the Cummings investigation in May 2010."*

247. On 9 March 2012, Enforcement produced a paper for Lord Turner explaining why Enforcement's investigation had focused on Mr Cummings. It stated in particular: *"Focused on Cummings because this was where the case looked strongest. Supervisors concerned at system and controls in corporate. At the time the limitation period for taking action against individuals was 2 years. Only at a later date did we put firm under investigation."*

248. On 21 March 2012, there was an FSA Board meeting. For the purpose of the meeting, Ms Cole produced a paper which addressed the issue as to why enforcement action had not been taken against '*other individuals*'. It stated that publication of the Final Notice in relation to BoS (i.e. on 9 March 2012) "*has increased media speculation*" about enforcement action against Mr Crosby and Mr Hornby. It set out reasoning as to why no such action had been taken against them, and largely repeated the points made in the paper produced by Enforcement on 16 February 2012 (paragraph 246 above).

249. On 3 April 2012, Enforcement updated the paper for Lord Turner prepared on 16 February. It stated (emphasis added): "*The key developments since our earlier memo are the settlement of the case against [BoS] and the conclusion of Cummings' representations to the RDC. Settlement with the firm means that a significant part of the story of why HBOS failed has been made public. These developments do not, however, alter the significant risks to the Cummings case of starting*

substantial work on the HBOS report if our case progresses to the Upper Tribunal…We therefore remain of the view that we should not begin substantive work until the enforcement proceedings have concluded."

250. On 24 April 2012, Enforcement produced an '*ExCo Summary Paper'* entitled '*Project Havana: Action against individuals*', in anticipation of an Extraordinary ExCo meeting due to take place on 25 April. At the Extraordinary meeting, ExCo was due to decide: "*Whether to: start an enforcement investigation into Andy Hornby and/or other former HBOS senior officers now; or keep the position under review pending further work relating to the report on why HBOS failed."* The Enforcement '*Recommendation'* to ExCo was that (emphasis added): (1) "*no further enforcement investigations are started into other individuals in respect of Corporate failings*"; and (2) "*However, in respect of the retail bank and HBOS's funding position, the situation is less clear: we recommend that a decision on this is kept under review while the report into why HBOS failed is taken forward. If that report identifies evidence suggesting personal culpability on the part of Hornby or others further action could be taken."* Thus, Enforcement's second recommendation was that any decision as to whether to investigate other senior managers in relation to two identified non-Corporate Division problems within HBOS should be deferred pending work on an HBOS report. Given the importance of this paper, it is exhibited to this Report at annexe 6.

251. The paper is important for several reasons. First, it is the document which contains the most comprehensive identification by the FSA of potential subjects for investigation in relation to the failure of HBOS; and yet it was produced over three years after the investigation into Mr Cummings had started and almost certainly after the expiry of the three year statutory limitation period for bringing disciplinary proceedings against any of the individuals referred to in the paper. It follows that it was almost certainly too late to bring disciplinary proceedings against those individuals, many of whom it appears the FSA had never previously considered investigating. As the paper frankly acknowledged (emphasis added): "*It is likely that the FSA is now time barred from taking disciplinary action against Hornby or any other individuals who may be guilty of competence related misconduct linked to the failure of HBOS. If the FSA has concerns that any individuals lack competence and capability and continue to pose a threat to the FSA's regulatory objectives, it remains open to us to investigate them with a view to seeking a prohibition order against them and/or the withdrawal of any approvals that they currently hold. To take such action we would need to establish that they were so incompetent as to be not fit and proper."*

252. Second, it reveals the paucity of the FSA's knowledge (after over three years of investigation) in relation to issues outside the Corporate Division. This reflected the fact that, by investigating Mr Cummings and the Corporate Division from the outset, other individuals were only ever considered through the prism of the Corporate Division. Thus, the paper expressly made the point that Enforcement's "*focus in assessing other individuals was on their oversight of Corporate: we did not investigate other divisions within HBOS or the wider reasons behind HBOS's failure, for example issues around funding and liquidity*", and: *"[w]hile we have a sufficiently clear understanding of Hornby's role in relation to Corporate matters, we do not have a detailed understanding of how he oversaw other divisions or how he dealt with the funding and liquidity issues that the firm faced prior to and during the financial crisis."* Enforcement was not, therefore, in a position, after three years of investigation, to provide any meaningful assessment of the potential culpability of any former senior managers in relation to non-Corporate Division problems. This, no doubt, explains why the recommendation was to await work on an HBOS report before considering whether to investigate any former senior managers in respect of non-Corporate Division problems.

253. The paper, in its '*Executive Summary*' recorded as follows (emphasis added):

> "*During the course of the Cummings investigation, Enforcement kept under review the position of other former HBOS senior officers, including Andy Hornby. After careful consideration, we decided not to place Hornby under investigation as we concluded that such an investigation*

had very limited prospects of success. We remain of this view having considered this afresh. Our focus in reaching this decision was on Hornby's oversight of Corporate matters: we did not consider his conduct in overseeing issues faced by other divisions (e.g. Retail or International) or group issues relating to funding and liquidity, which were not covered by our work….

The possible investigations we think we could realistically pursue would be into other individuals in Group Risk (Dan Watkins and Peter Hickman) and Group Finance (Phil Hodkinson and Mike Ellis) in relation to failings in Corporate, or into Hornby or others in relation to potential failings in the retail bank and HBOS's funding position."

254. The paper contained a section entitled '*Enforcement's assessment of other individuals*'. It then dealt with Enforcement's assessment (in the context of their oversight of the Corporate Division) of Mr Hornby, Lord Stevenson and Mr Crosby. Then, under '*Other individuals*', it dealt (briefly) with Dan Watkins (Group Risk Director from February 2006 to September 2007), Peter Hickman (Group Risk Director from September 2007 onwards), David Fryatt (Head of Group Internal Audit), Phil Hodkinson (Group Finance Director until September 2007) and Mike Ellis (wrongly identified as Group Finance Director from September 2007 onwards; in fact he held this role from 1 January 2008). Prior to this paper, most of these '*other individuals*' had never previously been considered by the FSA as potential targets for investigation.

255. The paper stated: *"Given, however, the significant responsibilities for risk management that were formally delegated to the Group Risk Director by the Board, and the slow progress that was made in developing an effective process for setting risk appetite across the group during the relevant period, the threshold for starting investigations into the conduct of both Watkins and Hickman in relation to Corporate's failings would certainly be met. However, establishing personal culpability may be challenging…"*. This appears to have been the first time that the FSA considered whether the statutory threshold test for investigating Mr Watkins and Mr Hickman was met. It also would appear from this paper that Enforcement must have been of the view that the statutory threshold test was met for investigating both Mr Hodkinson and Mr Ellis (given the view that "*possible investigations*" into their conduct could "*realistically*" be pursued). Again, this appears to have been the first time that the FSA considered whether the statutory threshold test for investigating Mr Hodkinson and Mr Ellis was met.

256. The paper explained that *"if the scope of [the investigation] is to be extended to another individual, the most obvious candidate would be Andy Hornby (followed probably by Dan Watkins and Peter Hickman, and then Mike Ellis and Phil Hodkinson)"*. The paper noted that the FSA had not interviewed Mr Hodkinson or Mr Ellis during the investigation into Mr Cummings. It is notable that both Mr Ellis and Mr Hodkinson were approved to perform SIF roles during the course of the investigation into Mr Cummings (Mr Hodkinson in November 2009 and Mr Ellis in May 2011; paragraphs 143 and 102 above, respectively). In fact, the FSA had interviewed Mr Hodkinson as part of the approval process in October 2009 and the note of that interview recorded that Mr Hodkinson *"indicated an inability to appreciate the strategic implications attached to being a Group FD"*.

257. The paper stated (emphasis added): "*We remain firmly of the view that the most culpable senior manager for the Corporate Division's failings is Cummings"*. The FSA was not in a position, after three years of investigation, to conclude that Mr Cummings was "*the most culpable senior manager*" for the failure of the firm as it had not investigated the firm. It is, however, worth recording that a number of the Report interviewees expressed the view that the reason why Mr Cummings was referred for investigation in February 2009 (i.e. three years earlier) was because he was regarded as the most culpable senior manager in relation to the failure of the firm.

258. On 25 April 2012, the Extraordinary ExCo meeting took place. The minutes record two action points for Ms McDermott, these being (1) by 28 June 2012, she was *"to verify if action can be*

taken against individuals in relation to the failure of HBOS and return to ExCo"; and (2) by 28 July 2012, she was to *"bring a paper to ExCo on the HBOS business model and whether it would meet the criteria for a competency case".* Unfortunately, these minutes do not appear to provide a coherent or accurate record of what ExCo required Ms McDermott to do. It appears (from a paper subsequently produced by Enforcement on 23 May 2012) that, in fact, Ms McDermott was told to prepare a further paper dealing with certain allegations made in December 2004 against the HBOS Board by Paul Moore (then HBOS's Head of Group Regulatory Risk). In particular, ExCo wanted Ms McDermott's paper to consider whether Mr Moore's allegation raised issues about the competency of various HBOS senior managers in late 2004, and "*how the Board members satisfied themselves that Corporate was properly controlled with a focus on the role of Group Risk*". In her Report interview, Ms McDermott accepted that "*…the minute is not as clear as it might be*".

259. On 26 April 2012, the FSA Board agreed that advice should be obtained from Leading Counsel "*on the extent to which starting the report [i.e. into the failure of HBOS] might prejudice our case [i.e. against Mr Cummings].*" As an internal FSA email that day stated: "*This followed on from the issue being raised at Adair's meeting with Tyrie on Tuesday, where Tyrie stated that it might be wise to take advice.*" On 8 May 2012, the FSA received that advice from Leading Counsel. The effect of the advice was that the best course would be to delay preparation of any HBOS report until after the conclusion of the disciplinary proceedings against Mr Cummings.

260. Therefore, by early May 2012, the position appears to have been as follows: (1) Enforcement had recommended to ExCo that no enforcement action should be brought against any other individuals in relation to the Corporate Division (paragraph 250 above); (2) Enforcement had recommended to ExCo that enforcement action against other individuals in relation to non-Corporate Division problems within the failed bank should be kept under review while the HBOS report was taken forward (paragraph 250 above); (3) Enforcement had recommended that work on the HBOS report should not begin while the action against Mr Cummings was continuing (paragraph 249 above), and this view had been endorsed by Leading Counsel (paragraph 259 above); and (4) ExCo had required Ms McDermott to produce a further paper dealing with Mr Moore's historic allegations against the HBOS Board (paragraph 258 above).

261. On 21 May 2012, there was an ExCo meeting. The minutes of that meeting record, under the heading '*Further consideration of action against individuals*', that two decisions were taken.

(a) The first was that: "*ExCo agreed in light of Counsel's advice that it could prevent the publication of the Decision Notice if we proceed at this point with the report. ExCo ultimately think that the publication of the Decision Notice and report is in the public's interest.*" It is unclear from this wording as to what decision was in fact reached.

(b) The second decision was that (emphasis added): "*ExCo agreed to the commissioning of a formal fact finding investigation which looks at the role and effectiveness of Group Risk in relation to identifying and controlling the significant prudential risks in HBOS and the extent to which matters were reported to the Board and the senior management team including the CEO. <u>The preliminary fact finding exercise is for the purpose of informing any further work, which may include enforcement investigations.</u>*"[36] It appears from a paper produced by Enforcement for Sir Hector Sants on 23 May 2012 (although it is not apparent from the ExCo minutes) that this review of the "*effectiveness of Group Risk*" "*would be a stand-alone review and would not be conducted as part of an enforcement investigation or a wider report in relation to the failure of HBOS*" i.e. this was not part of any work on the proposed HBOS report.

(36) Following her Report interview, Ms McDermott made the point that, although the minutes "*are not as clear as they could be*", the underlined sentence "*clearly indicates that a decision was made to defer consideration of investigating other individuals pending outcome of fact finding investigation into Group Risk*".

(c) The ExCo minutes also record that Enforcement was to consider "*whether the discussed approach is an appropriate course of action*". It is not clear from the minutes as to what "*the discussed approach*" was a reference to i.e. the first or second decisions, or both (or neither).

262. On 23 May 2012, Enforcement produced an ExCo Summary Paper dealing with Mr Moore's allegations, and the issue relating to Group Risk. The paper concluded (emphasis added): "*We do not consider that the Paul Moore allegations or follow up work provide grounds for further enforcement work against individuals. In terms of oversight of Corporate and the role and effectiveness of Group Risk we do appear to meet the test for an investigation into certain individuals, although it is likely to be difficult to establish personal culpability. We will not, however, be able to establish the strength of any likely case without an enforcement investigation or until any report into why HBOS failed considers this topic. Our preferred option is not to start an enforcement investigation at this time and keep this decision under review as the HBOS report uncovers new evidence.*"

263. It is not apparent when the ExCo Summary Paper of 23 May 2012 was considered by ExCo, as there do not appear to be minutes of an ExCo meeting at which this paper was considered(37). There was, however, a meeting of the FSA Board the following day (i.e. 24 May 2012). The minutes of that meeting, under the heading '*Proposals for a report on HBOS*', record the Board noting (1) "*the legal advice provided from Counsel was robust and advised that there were significant risks in publishing, or even starting a review into the causes of the failure of HBOS, in advance of Upper Tribunal proceedings*"; (2) that the '*Executive*' proposed carrying out "*revised investigatory work (under s165 of FSMA) to review the risks and controls at the centre of HBOS*", which work would be "*drawn to ensure there was no overlap*" with any appeal by Mr Cummings to the Upper Tribunal; and (3) "*following the [Upper] Tribunal, a report on the failure of HBOS would be proposed to be published…*".

264. On 12 June 2012, an internal Enforcement paper was produced entitled '*Peter Cummings: risks of the concurrent report process*'. Again, one of the risks identified in the paper was the possibility of having to disclose in the enforcement action against Mr Cummings material obtained during the preparation of the report into the failure of HBOS (a point previously made by Enforcement in the paper of 12 January 2012, as quoted in paragraph 245 above). On 28 June 2012, Leading Counsel again advised. The effect of the advice was that there were very significant risks to the case against Mr Cummings which would be associated with the production of an overall summary of why HBOS failed. It therefore appears that, as at 28 June 2012, there was still a live issue as to whether work would begin on an HBOS report while the enforcement action against Mr Cummings was ongoing.

265. On 24 July 2012, Enforcement produced a '*Draft ExCo Summary Paper*' entitled '*HBOS: Further work*'. It is unclear whether this document remained in draft, and whether it (or any finalised version) was ever presented to ExCo. There do not appear to be minutes of an ExCo meeting at which this paper (or any finalised version) was considered. The document recorded that *"A number of decisions have already been made by ExCo in relation to any further work to be conducted in relation to HBOS: (1) Priority should be given to concluding the Cummings case; (2) In the light of Counsel's advice, a full report into why HBOS failed should not be published prior to the resolution of the Cummings case, but we can explore what limited work can be conducted by the Review Team now, on the basis that a report will not be published until the resolution of the Cummings case; (3) Given the criticisms of Group Risk/Finance in the Bank of Scotland plc Final Notice, ExCo has asked for further work to be conducted to identify if any other individuals should be the subject of disciplinary actions, such work could be used in any report on why HBOS failed which may ultimately be produced …"*. The '*Recommendation'* was that: "*In light of the risks to the Cummings case we recommend that careful consideration is given to the scope of any further*

(37) For the purpose of producing this Report, minutes of all relevant ExCo meetings were requested and apparently provided.

work in relation to the failure of HBOS". It did, however, recommend that limited work could be conducted but that it should "*not extend to a summary of why HBOS failed*".

266. The upshot was that (1) no other investigations were started, and (2) no work on an HBOS report began prior to the compromise reached between the FSA and Mr Cummings on 3 September 2012 (paragraph 242 above). Insofar as this was the consequence of positive decisions made by ExCo during this period, the poorly drafted ExCo minutes do not properly record such decisions being made.

C.8 The FSA's evidence to the PCBS

267. On 18 January 2013, the FSA provided the Parliamentary Commission on Banking Standards ('PCBS') with written evidence for the purpose of its examination of sanctions and the approved persons' regime. The FSA's evidence included reference to the FSA's enforcement decisions in relation to HBOS and, in response to the question *"Did the FSA consider taking enforcement action against anyone else from HBOS? If not, why not?"*, the FSA stated (emphasis added):

> *"The FSA is producing a report on the failure of HBOS which will set out what it believes were the reasons for the failure of the bank. It will also explain why the Enforcement action focused on Peter Cummings' management of the Corporate Division and collective failings in the governance of this division at Group level.*
>
> *In the FSA Board report into the failure of RBS, we explain the general principles that apply when the FSA decides whether to take action against an approved person such as a senior manager. The legislation requires the FSA to prove that either the individual has failed to comply with APER or that he or she was otherwise knowingly concerned in a breach by the firm. If it can demonstrate either of these matters, it can impose a financial penalty, publicly censure that person and/or suspend or restrict their approval. In more serious matters, if it appears that the individual is not a fit and proper person, the FSA can also seek a prohibition order preventing the individual from holding either any roles or specific roles within the financial services industry.*
>
> *The burden of proof is on the FSA and the standard of proof required is the civil standard (ie the balance of probabilities). However, the FSA can take disciplinary action against an approved person only where there is evidence of personal culpability on his or her part. Personal culpability arises either where the behaviour was deliberate or where the approved person's standard of behaviour was below that which would be reasonable in all the circumstances at the time of the conduct concerned.*
>
> *For example, in cases where there is no indication of a lack of integrity on the part of a senior manager under investigation, the issue may be whether he or she has acted without due skill, care and diligence in carrying out the approved role, or whether he or she is competent to carry out the role. In such a case the FSA would have to show that the actions or decisions of that senior manager fell below those which could be considered reasonable taking into account all the relevant circumstances at the time.*
>
> *The Enforcement investigation into the conduct of Peter Cummings was begun in March 2009 in the context of £7 Billion impairment losses (which by the end of 2011 stood at £25 Billion) recognised on the HBOS Corporate book following the merger with Lloyds. The investigation therefore focused on the serious issues within HBOS's Corporate Division and its oversight. The need to focus on Mr Cummings was clear given his role as both the CEO of the Corporate Division and also a member of the Group Board.*

HBOS's federal structure gave Mr Cummings and other divisional chief executives significant autonomy in how they ran their divisions. Whilst other members of the Board wanted Mr Cummings to increase the Corporate Division's profitability he was in a unique position to understand, and advise his colleagues on the Board about the risks inherent in the Corporate book and the deficiencies in the division's control environment. At the same time the structure of Mr Cummings' remuneration meant that he benefited directly from an increase in the profitability of Corporate's business.

Mr Cummings was also personally involved in the sanctioning of high value/high risk Corporate transactions and personally involved in the oversight of stressed transactions on the Corporate book, unlike other members of the Board.

The Board placed significant reliance on Mr Cummings' experience and expertise as a corporate banker, and Mr Cummings' status as the highest paid member of the Board reflected this.

The evidence gathered in the investigation demonstrated clearly that the most culpable senior manager for the Corporate Division's failings was Peter Cummings. Nonetheless Enforcement obtained information about the roles that other senior HBOS officers played in overseeing the Corporate Division and kept under review whether the scope of its investigation into the failures within Corporate should be extended to include other individuals. However, the prospects of successfully establishing personal culpability against other individuals were considered to be very low and the decision was taken to focus on the case against Mr Cummings."

D. Assessment of the scope of the FSA'S enforcement investigations

D.1 Overview of assessment

268. In summary, I consider that the scope of the FSA's enforcement investigations in relation to the failure of HBOS was not reasonable. The decision-making process adopted by the FSA was materially flawed; and the FSA should have conducted an investigation, or series of investigations, wider in scope than merely into the conduct of Mr Cummings and the Corporate Division. At a minimum, Mr Hornby should also have been investigated in relation to the failure of HBOS.

269. The key problem with the initial decision-making process (i.e. in the period between early December 2008 and 26 February 2009) was that the only person whose possible misconduct was given proper consideration for investigation was Mr Cummings (this being in relation to the Corporate Division). The FSA gave no proper consideration to the possibility of investigating any additional individuals including other members of the Board at the date of failure, such as the CEO and Chairman, even though it was apparent to the FSA (certainly to Supervision) that there had been significant problems within the failed bank extending beyond the Corporate Division (including problems in the International and Treasury Divisions, and with the reliance on wholesale funding).

270. While the problems in the Corporate Division had generated the most substantial losses (in absolute terms) and justified an investigation of Mr Cummings as former CEO of that division (for the reasons set out in the ERD), the FSA was aware that there were further significant problems within the bank that had contributed to its failure. Indeed, in his Report interview, Mr Adamson (Director of Major Retail Groups Division, in Supervision) accepted that, prior to late February 2009, the FSA was aware that there was "*a quite fundamental problem with the way that the bank had been run as a whole*". Given the FSA's awareness that the problems in the failed bank extended beyond the Corporate Division, it was unreasonable that the decision-making process focussed solely on Mr Cummings and the Corporate Division and did not, in addition, consider other parts of the bank and other problems within the bank.

271. The fact that the only person whose name appears to have been discussed in the initial decision-making period was that of Mr Cummings is particularly surprising given that the trigger for considering enforcement action was not the apparent misconduct of Mr Cummings, or the losses in the Corporate Division, but the failure of HBOS. The FSA should, in such circumstances, have engaged in a decision-making process which involved some preliminary assessment of the causes of that failure, thereby enabling it to identify those individuals in respect of whom the statutory threshold test for conducting an investigation was met. It did not do so. Furthermore, the FSA did not properly consider an investigation into the failed bank itself even though, as Ms McDermott said in her Report interview, while there was a focus on investigating individuals, the normal position was nevertheless for a firm to be considered for investigation where the firm appeared to have breached a statutory requirement: *"Typically, in most of our cases, we do look at institutions as well"*. In his Report interview, Sir Hector Sants said that he expected that Supervision and Enforcement would conduct a preliminary assessment of the causes of failure so as to identify potential subjects for enforcement action, whether individuals or the firm. Plainly this should have been done, but it was not.

272. Instead, Mr Cummings was the only potential subject in respect of whom the FSA even considered whether the statutory threshold test for conducting an investigation was met. This appears to have been because (1) there was a "*richness of information*" available to Supervision relating to Mr Cummings and the Corporate Division, and (2) the Corporate Division was experiencing the greatest losses. Thus, the view of a number of Report interviewees who had held positions within the FSA was that Mr Cummings was "*the most culpable*" former senior manager in respect of the failure. However, the problem with this reasoning was that it presupposed that a proper comparative assessment had been made of the conduct of Mr Cummings as against the conduct of other individuals who were potentially culpable in respect of the failure. In fact, prior to the referral of Mr Cummings for investigation, the FSA did not conduct any comparative assessment which would have enabled it to reach this view.

273. This decision-making process set the FSA on a path which made it highly likely that there would be no enforcement action in relation to matters outside the Corporate Division. This was for two reasons.

274. First, the federal structure of HBOS meant that an investigation of Mr Cummings and the Corporate Division would almost inevitably fail to throw any significant light on the non-Corporate Division problems within the bank, such as the problems in the Treasury and International Divisions and with the reliance on wholesale funding. Therefore, the nature of the investigation conducted by the FSA meant that the conduct of other former senior managers would only ever be viewed through the prism of their involvement with the Corporate Division. As Mr Walker accepted in his Report interview, an investigation of Mr Cummings and the Corporate Division would never, save by accident, uncover evidence about problems other than in relation to the Corporate Division, such as problems in the Treasury and International Divisions.

275. Second, the statutory time limit for starting disciplinary proceedings against individuals (paragraph 28 above) meant that any investigation into a former senior manager needed to be started expeditiously. At the time when the FSA first started considering enforcement action in relation to the failure of HBOS (i.e. December 2008), the FSA was required to issue a Warning Notice within two years of it becoming aware of the alleged misconduct (this changed to three years in June 2010). In his Report interview, Mr Walker said that "*…two years was always tight… on these cases*"; and Mr Jones, in his Report interview, made the point that about seven to eight months of the two year period tended to be taken up with "*processing type stuff*" (e.g. drafting the PIR, the legal review of the PIR, waiting for the subject to respond to the PIR, getting papers to the RDC). Prior to starting the investigation of Mr Cummings, the FSA does not appear to have considered when the two year time limit began to run in relation to his potential misconduct, and would therefore expire. When it did consider this issue (between May 2009 and March 2010), it concluded that time probably began to run in mid-June 2008, so that any Warning Notice needed to be issued by mid-June 2010. The FSA did not consider the issue of the expiry date in relation to other former senior managers (such as Mr Hornby or Lord Stevenson) and therefore had no reason to believe that the expiry date would be materially different from the mid-June 2010 expiry date applicable to Mr Cummings. Moreover, no Report interviewee offered any such reason even with the benefit of considerable hindsight.

276. During the Report interviews, a number of interviewees emphasised that the investigation of Mr Cummings was only regarded as the "*starting point*", and that the FSA was always prepared to extend the scope of the investigation into the conduct of others. This point was indeed stressed again by Sir Hector Sants and Ms Cole in written submissions made after their Report interviews. However, given the statutory time limit, it was an unsound approach to take Mr Cummings, alone, as a "*starting point*". This is highlighted by the content of the ExCo Summary Paper of 24 April 2012 (paragraphs 250 to 257 above), which was produced by Enforcement over three years after the start of the investigation of Mr Cummings. It acknowledged that "*we did not investigate other divisions within HBOS or the wider reasons behind HBOS's failure*", and that: "*It is*

likely that the FSA is now time barred from taking disciplinary action against Hornby or any other individuals who may be guilty of competence related misconduct linked to the failure of HBOS." Thus, by taking Mr Cummings, alone, as a "*starting point*", too narrow an investigation was conducted, and others who might have been guilty of misconduct were never investigated prior to the likely expiry of the statutory time limit for bringing disciplinary proceedings.

277. It should have been appreciated by the FSA during the initial decision-making process (i.e. December 2008 to February 2009), that the combined effect of the federal structure of HBOS and the statutory time limit would make it highly unlikely that those responsible for the "*wider reasons behind HBOS's failure*" (to use the words of the ExCo Summary Paper of 24 April 2012) would ever be investigated if Mr Cummings, alone, was the "*starting point*". However, it does not appear that anyone within the FSA, in the period leading up to the referral of Mr Cummings on 26 February 2009, ever expressly considered whether, by starting an investigation of Mr Cummings alone, time might run out in respect of other former senior managers; as indeed it did.

278. Given the FSA's awareness, in the period between early December 2008 and 26 February 2009, of the significant problems in the failed bank beyond those in the Corporate Division (i.e. the "*wider reasons behind HBOS's failure*"), it should have commenced a wider investigation from the outset. The investigation should not have been confined to Mr Cummings and the Corporate Division. The FSA should additionally, at a minimum, have investigated Mr Hornby, as Group CEO of the bank at the date of its failure. Such an investigation would have enabled the FSA to investigate Mr Hornby's potential culpability in respect of those other problems, and indeed his potential culpability for the problems within the Corporate Division. It would also have enabled the FSA to assess, during the investigation of Mr Hornby, whether there were other former senior managers who should also be investigated in respect of the wider range of problems within the bank.

279. In the light of the narrow scope of the investigation started by the FSA in early 2009 (i.e. into Mr Cummings and the Corporate Division), it was important (as various Report interviewees accepted) that the FSA continued to monitor the scope of the investigation and, in particular, that it considered whether it was appropriate to expand the scope of the investigation including into the conduct of others. Any decision to expand the scope needed to be taken expeditiously given the statutory time limit. Once the investigation of Mr Cummings had begun, the FSA should therefore have considered, on a regular basis, whether there were other additional potential subjects to investigate.

280. For example, when it became apparent to the FSA, early in 2009, that the problems in the International Division were considerably more serious than the FSA had originally appreciated, it should have considered investigating Mr Matthew (CEO of the International Division at the date of failure). Indeed, Ms Williams (Supervision) raised the issue of investigating Mr Matthew in her email of 29 June 2009, sent to various other people within Supervision (paragraph 129 above). However, the email was neither forwarded to, nor discussed with, anyone in Enforcement. It appears to have generated no discussion.

281. During the Report interviews, it became apparent that some former FSA employees thought that the possible expansion of the scope of an investigation was a matter for Supervision to raise with Enforcement; others thought it was a matter for Enforcement to raise with Supervision; and others thought it was a matter which would be raised by a dialogue between Supervision and Enforcement. Had there been a proper formalised procedure whereby Supervision and Enforcement together considered whether there were circumstances justifying the expansion of the scope of the investigation, then the expansion of the scope of the investigation would, no doubt, have been properly considered. However, it was not.

282. Then, in early 2010, the FSA considered, it appears for the first time, whether to start an investigation of Mr Hornby, albeit only in relation to his oversight of the Corporate Division and not in respect of the other problems within the failed bank. The FSA concluded that the statutory threshold test for investigating Mr Hornby was met, but nevertheless decided that it was not appropriate to investigate him. This decision was not a reasonable one, and Mr Hornby should have been investigated at this point (having not been investigated more broadly from earlier on in the enforcement process).

283. The consequence of the above matters was that the investigation carried out in relation to the failure of HBOS was, from the outset, too narrow in its focus. The decision, in April 2011, to investigate the firm did not in any material way broaden the scope of the existing investigation. The action taken against the firm was in relation to its monitoring and control of the Corporate Division, and essentially involved analysing the material obtained in the investigation of Mr Cummings so as to apply to the firm. This further enforcement action did not, therefore, expand the investigation beyond the Corporate Division and into the other problems within the failed bank. In any event, by this time, the statutory time limit for bringing disciplinary proceedings against other former senior managers (which had, in June 2010, increased to three years) was likely to be close to expiring, with the result that it was almost certainly already too late to start a fresh investigation of any other former senior managers (for the purpose of bringing disciplinary proceedings).

284. Nevertheless, the FSA's decision in April 2011 to commence an investigation into BoS was, in itself, a reasonable one. The statutory threshold test for investigating the bank was clearly met, and there were sound reasons for bringing disciplinary proceedings against a systemically important bank whose systems and controls failures had been so substantial that the bank had failed. However, as explained below (paragraph 336), the late decision to bring enforcement action against the bank highlighted several deficiencies in the FSA's initial decision-making process, i.e. in the period up to 26 February 2009.

285. In March and September 2012 respectively, the FSA decided to compromise the disciplinary and/or prohibition proceedings brought against BoS and Mr Cummings. Those decisions reflected a reasonable judgment as to what was realistically achievable by way of penalty in each case and the inherent litigation risks. They also ensured that the FSA achieved a public outcome.

286. However, the upshot of the enforcement action taken by the FSA in relation to the failure of HBOS was that only one former senior manager faced disciplinary and/or prohibition proceedings, namely Mr Cummings; and those former senior managers potentially culpable in respect of the other problems within the failed bank were never even considered for investigation (in relation to those other problems) in a proper or timely manner and, if now investigated, could not face disciplinary proceedings given the expiry of the statutory time limit. That is an unsatisfactory situation.

287. The FCA should now consider whether it would be appropriate to investigate other former members of HBOS's senior management, albeit with a view to prohibition proceedings (in respect of which no financial penalty can be imposed).

D.2 The initial decision-making process: 3 December 2008 to 26 February 2009

288. I consider that the FSA's initial decision-making process, in the period between 3 December 2008 and 26 February 2009, relating to the scope of possible enforcement action arising from

the failure of HBOS, was materially flawed. The facts relevant to this conclusion are set out in section C(1) above.

289. The trigger for consideration by the FSA of possible enforcement action was (as the Report interviewees accepted) the failure of HBOS, rather than the apparent misconduct of any particular individual such as Mr Cummings. It was, therefore, necessary that the decision-making process should include consideration of (1) the range of individuals who might have been guilty of misconduct in relation to the failure of HBOS (which itself required the FSA to form some preliminary view as to the causes of the failure); (2) whether the firm itself might have contravened a rule made by the FSA in relation to that failure; and (3) which of those subjects (i.e. both individuals and firm) should be investigated.

290. Sir Hector Sants, in his Report interview, accepted that the FSA should have engaged in such a decision-making process, and described this as the FSA's '*standard approach*' when considering enforcement action. He stated as follows:

> "*…the standard approach would be for Supervision to assess what happened and what went wrong in terms of looking at the business model as opposed to individuals…Then, having made that assessment of what went wrong, to then ask the question in conjunction with Enforcement as to what was the right type of investigation to formally commence. And I would expect, and I have no reason to believe they didn't, ask that question in respect of all possible ways forward i.e. all relevant senior executives and institution…I would expect them to initially determine why they thought the institution failed…*"
>
> He later added: "*I would have expected…a thorough dialogue as to what the right enforcement case was to take. Part of that thorough dialogue would include a comprehensive assessment of the information available to the FSA at the time of why the bank failed and what – and, based on that assessment of why the bank failed, what action, if further action, to take.*"

291. The need for the FSA to engage in a "*comprehensive assessment of the information available to the FSA at the time of why the bank failed*", and then to consider "*all possible ways forward i.e. all relevant senior executives and institution*" was particularly strong in the circumstances, given that:

(a) It was one of the FSA's '*strategic priorities*' at this time to take more action against senior management and therefore to investigate more individuals, because the FSA considered that taking action against individuals had a particularly important deterrent value (paragraph 44 above).

(b) It was the FSA's specific objective in the case of the failure of HBOS, according to Sir Hector Sants and Ms Cole among others, to ensure that the FSA took all enforcement action that could reasonably be taken. Sir Hector Sants, in his Report interview, used the phrase: "*any enforcement action that could be taken here should be taken*" (paragraph 62 above).

(c) It was apparent, during this initial decision-making period, that the problems in the failed bank extended beyond the Corporate Division, and included problems in the Treasury and International Divisions[38] and with the reliance on wholesale funding. In her email of 22 December 2008 (sent to Enforcement), Ms Williams (Supervision) referred to "*other equally significant issues*" i.e. in addition to those in the Corporate Division (paragraph 72 above). The FSA should, therefore, have considered which former senior managers were potentially culpable in respect of those other equally significant issues, and whether they should be investigated.

(38) Although the impairment loss of £958 million in the International Division was not announced until 27 February 2009 (paragraph 103 above), Supervision knew about those losses prior to the public announcement.

(d) No Report interviewee suggested that this was a 'rogue trader' type situation in which it could confidently be said from the outset that one man had brought down the bank. This was not, therefore, a situation in which it was safe to focus all attention on one person. The FSA identified and selected Mr Cummings for investigation because of the "*richness of information*" available about him and the Corporate Division due to Supervision's previous dealings in relation to the Corporate Division. This should not, however, have caused the FSA to fail to consider other individuals as potential subjects for investigation.

(e) The FSA was required, as a matter of good administration, to consider the full range of potential subjects when deciding whether or not to start investigations and, if so, against whom. The email of 22 December 2008 from Mr Davies (Supervision) to Ms Williams (Supervision) expressly acknowledged the "*…need to be fair and consistent in who we target, although I don't think this means that we must go for the firm instead of named SIF individuals. If, as you imply, there were different problems with different SIF individuals responsible, this suggests to me that we should take action against more than one individual and not target one scapegoat…*" (paragraph 74 above).

292. Despite the need for the FSA to conduct a proper assessment of the range of potential subjects for enforcement action prior to 26 February 2009 (such as by adopting what Sir Hector Sants described as the '*standard approach*'), it failed to do so. In particular, (1) no proper consideration was given as to whether or not to investigate any former senior managers other than Mr Cummings; and (2) no proper consideration was given as to whether or not to investigate the firm. A reasonable decision-making process required the proper consideration of these matters.

293. No proper consideration of other individuals, in the period up to 26 February 2009:

(a) It is apparent from both the contemporaneous documents and the Report interviews that no proper consideration was given as to whether or not to investigate any former senior managers other than Mr Cummings. In particular, the contemporaneous documents contain no discussion of possible enforcement action against anyone other than Mr Cummings; the Report interviewees could recall no discussion of any specific individuals other than Mr Cummings; and the questions, very properly, raised by Ms Williams, Mr Smith and Mr Jones as to whether others should be investigated in all the circumstances, never appear to have led to any discussion of this key matter (paragraphs 72, 74 and 84 above). In their Report interviews, Mr Adamson was clear that there had been no such consideration, as was Mr Smith who stated: *"…the name Andy Hornby rings a bell. Obviously it should ring a bell but I don't think he ever – I don't think his name was ever raised in the context of "Should we also refer him as well.""* Although Ms Williams did recall discussions about more numerous individuals than just Mr Cummings, she could not recall when these discussions had taken place and could not be sure that they had occurred pre-referral at all, i.e. pre-26 February 2009; and she did not identify which particular individuals might have been discussed. If anyone other than Mr Cummings was discussed for potential investigation in this period (and there is no evidence of any such discussion), there was plainly no proper consideration of investigating that individual.

(b) It is clear that, other than in relation to Mr Cummings, no consideration was given by the FSA as to whether the statutory threshold test for investigating any former senior manager was met; and, if so, whether it was appropriate in all the circumstances to investigate that individual. In my view, where a systemically important bank had failed, had arguably been overly reliant on wholesale funding, and had suffered and was continuing to suffer enormous losses and impairments in various divisions (including the Corporate, International and Treasury Divisions), there were clearly "*circumstances suggesting that*" the entire Board of the bank at the date of failure, and also the CEO of the Treasury Division who was not actually a Board member, "*may be guilty of misconduct for the purposes of section*

66"[39]. The statutory threshold test for conducting investigations (paragraph 39a above) was therefore clearly met in the case of those individuals. Given that the statutory threshold test for investigating those individuals was met, the FSA's guidelines (paragraphs 42 and 43 above) then required it to consider whether to investigate those individuals having regard to all relevant circumstances: "*If the statutory test is met, [the FSA] will decide whether to carry out an investigation after considering all the relevant circumstances.*" The FSA should, in relation to those individuals, have considered whether it was appropriate, in all the circumstances, to bring enforcement action against each such individual. For example, there should have been a proper consideration by the FSA as to whether or not to bring enforcement action against Mr Hornby and Lord Stevenson. There was, however, no such consideration.

294. No proper consideration of the firm itself, in the period up to 26 February 2009:

(a) There are no documents recording any proper consideration by the FSA (in this initial decision-making period) as to whether or not to investigate the firm. Although there are several emails in this period in which this issue appears to have been raised (emails of 6 December 2008 and 29 January 2009, at paragraphs 66 and 84 above), those emails do not seem to have generated any discussion. In early 2011 (i.e. two years later), Enforcement was considering bringing action against the firm, and the question was asked by Ms Evans in her email of 7 March 2011 (paragraph 201 above) as to whether there was a record of the reason for not bringing enforcement action against the firm from the outset. It became apparent from the responses to that email that there was no such record, and that no documents existed recording any discussion of the matter. No Report interviewee could recall any consideration being given (in the initial decision-making period) as to whether or not to investigate the firm and, insofar as there was any recollection, it appears that no proper consideration was given to this issue. Mr Adamson said in his Report interview: "*… we weren't really thinking about the firm at that point. It was against individuals.*"

(b) The statutory threshold test for investigating the firm (paragraph 39b above) was clearly met. When, in early 2011, Enforcement was considering bringing action against the firm, a paper of 15 February 2011 (paragraph 192 above) recorded that, from the outset, "*…there was likely to be a strong case against the firm…*"; and, as Ms Evans said in her Report interview, it was "*…an absolute no-brainer that there was a breach by the firm*", because "*[a]ll the breaches by Mr Cummings were, in effect, attributable to the firm*". Given that the statutory threshold test for investigating the firm was met, the FSA's guidelines (paragraphs 42 and 43 above) then required it to consider whether to carry out an investigation having regard to all relevant circumstances. The FSA did not carry out that exercise.

(c) Although, at this time, the FSA was focussing on action against SIFs, it was not to the exclusion of enforcement action against firms, as Ms McDermott acknowledged in her Report interview (paragraph 271 above). The FSA should, therefore, have considered whether enforcement action against the firm was appropriate.

(d) The Final Notice issued against the firm on 7 March 2012 publicly censured BoS for the "*very serious misconduct of the Firm*" (paragraph 233 above). Although the FSA (entirely reasonably) did not seek the imposition of a financial penalty against the firm, the internal FSA view was that a penalty of £100 million would have been justified by reason of the seriousness of the firm's misconduct in relation to the Corporate Division (paragraph 224 above). Such a penalty would, at that time, have been the largest fine ever imposed on a firm. This highlights (albeit with hindsight) the deficiency in the initial decision-making process, whereby no proper consideration was given to the bringing of enforcement action against the firm.

(39) In particular, there were circumstances suggesting possible breaches of Statements of Principle 5, 6 and 7 (see paragraph 23 above).

295. Further deficiencies in the decision-making process include the following:

(a) Absence of records: There was and is almost a complete absence of any records of any decision-making process. There are no minutes, papers, or agendas; and indeed very little by way of documentary record. In particular, there are no documents reflecting or recording any discussion between Supervision and Enforcement relating to the range of problems that led to the failure of the bank i.e. (using Sir Hector Sants' words) "*what went wrong*" and "*why the bank failed*". Indeed, there appears to have been no, or certainly no significant, discussion between Supervision and Enforcement beyond the problems in the Corporate Division. There is no clear record of the apparently critical meeting on 9 January 2009 (paragraphs 76 to 79 above).

(b) No clearly identifiable decision maker or reasons: None of the Report interviewees had any recollection as to when, how, and by whom it was decided that Mr Cummings would be the subject of enforcement action. While it appears from the documents that this decision was probably taken on 9 January 2009, none of the four participants at the apparently critical meeting could remember anything about it. The overall view of the Report interviewees appears, in effect, to have been that the decision was taken by means of an iterative process of discussion; but the net result of this was that none of the Report interviewees took responsibility for actually having made the decision.

(c) Failure to heed voices of caution: There was a failure to heed a series of voices expressing concern at the prospect of limiting the investigation to Mr Cummings alone. Prior to the signing of the ERD, Ms Williams (Supervision), Mr Jones (Enforcement) and Mr Smith (Enforcement) had each raised the question as to why Mr Cummings was the only person being referred to Enforcement for investigation (paragraphs 72, 82 and 84 above); and it appears that no response was ever received by any of them to this key question. There is certainly no documentary record of this question being discussed and answered; and none of the witnesses recalled any such discussion and answer.

(d) Failure to respond to, and deletion of, critical questions in the draft ERD: From an early stage in the drafting process, the ERD contained two critical questions, i.e. "*Please explain whether we consider these to be failings at Group level of HBOS or if this is something which Cummings had responsibility for"* and "*Please explain to what extend [sic] the concerns extend beyond Cummings to Group and why no other individuals should be referred*" (paragraph 85 above). These questions were of obvious importance and yet no-one in Supervision or Enforcement ever attempted to answer them: indeed, Ms Williams, in Supervision, had also raised the question as to why pursue only Mr Cummings, and she had never received any answer (paragraph 89 above).

(e) Use of the wrong ERD: For reasons which are unexplained, the FSA used an old ERD Template when producing the ERD for Mr Cummings rather than the revised December 2008 version. The revised ERD included a section headed '*Probability of success and importance assessment'*, which would have required those drafting the ERD to have "*… assigned both a 'probability of success' and an 'importance' rating from the rating range Low, Medium Low, Medium High or High"* (paragraph 45 above). While there is no reason to believe that use of the correct ERD would have affected the nature of the decision-making process or the decisions made, it was nevertheless a deficiency.

296. This flawed decision-making process set the FSA on a path which meant that it was highly likely that there would be no enforcement action in relation to matters outside the Corporate Division (for the reasons explained in paragraphs 273 to 277 above). It also meant that there was no proper record as to why various potential subjects for investigation were not investigated.

D.3 The initial scope of the investigation; and the decision in early 2009 to investigate Mr Cummings

297. I consider that the FSA's decision in early 2009 to investigate Mr Cummings was, in itself, a reasonable one. However, the FSA should have conducted a wider investigation, or series of investigations from early 2009; and, at a minimum, should have investigated Mr Hornby. Therefore, while it was reasonable to investigate Mr Cummings, it was not reasonable that the initial scope of the investigation did not extend beyond Mr Cummings to include, at a minimum, Mr Hornby. The minimum reasonable enforcement response in early 2009 was an investigation of Mr Cummings and also of Mr Hornby.

298. The reason this conclusion is expressed as a 'minimum' is that it is important to emphasise that there was no single appropriate/reasonable enforcement response to the failure of HBOS. This was not a situation where the conduct of only one person appeared to have led to the collapse of the bank, as might be the case with a 'rogue trader'. Rather, a substantial multi-divisional institution had failed as a result of a number of factors, in respect of which the FSA inevitably had only a partial understanding. There was, therefore, a range of possible enforcement responses which it would have been reasonable for the FSA to have conducted, bearing in mind the referral criteria, including the FSA's regulatory objectives and strategic priorities.

299. For example, the FSA might have decided, given the public interest in responding to the failure of this systemically important bank, to investigate the entire Board at the date of failure in order to decide which (if any) of those Board members should thereafter be the subject of disciplinary and/or prohibition proceedings. Such an expansive series of investigations would have been an enormous commitment for the FSA in terms of resources, and might well have been extremely difficult to co-ordinate. The fact that the FSA did not adopt this approach does not mean that it acted unreasonably.

300. As stated above, the FSA's decision in February 2009 to investigate Mr Cummings was, in itself, a reasonable one. The basis of that decision was set out in the ERD signed on 26 February 2009 (a copy is attached at annexe 4, and the '*Summary*' is quoted in paragraph 97 above). The statutory threshold test for investigating Mr Cummings was met; and the FSA reasonably concluded that it was appropriate, in all the circumstances, to start such an investigation. As stated in the ERD, by the end of November 2008, the Corporate Division had disclosed impairment losses of £3.3 Billion for an eleven month period and, in fact, the actual losses (as announced in February 2009) were almost £6.7 Billion. In the light of those impairments and for the reasons set out in the ERD, the decision to investigate Mr Cummings, as former CEO of the Corporate Division, was a reasonable one(40).

301. The FSA should, however, have conducted an investigation, or series of investigations, wider in scope than merely into the conduct of Mr Cummings and the Corporate Division, given the factors set out in paragraph 291 above. Three factors require particular emphasis in this context:

(a) The FSA's awareness of the other significant, non-Corporate Division, problems within the failed bank. In particular:

(i) The FSA was aware, by December 2008, that the problems within HBOS were not confined to the Corporate Division; and indeed that there were (as Ms Williams stated in her email dated 22 December 2008, as more fully quoted in paragraph 72 above) "*other equally significant issues*", these being "*the funding gap and the large portfolio of structured credit that have contributed to HBOS's problems (and possibly we could add the*

(40) In his Report interview, Mr Cummings expressed the view that it was not reasonable to investigate him. While it is understandable that Mr Cummings holds this view, it was not based on an analysis of the statutory scheme but was based on his view that his conduct was reasonable and was always supported by the Board of HBOS.

heavy weight of specialised mortgages but this has yet to play out)." As she said in her Report interview: "*At that point clearly I didn't appreciate International*".

(ii) The FSA became aware, during the course of February 2009, of the substantial problems in the International Division (paragraphs 103 and 104 above). In her Report interview, Ms Thomas (Supervision) confirmed that, by late February 2009 when HBOS announced its Preliminary Results for the year ended 2008, "*…we had started to appreciate that there would be a blood bath on international*". Mr Adamson (Director of Major Retail Groups Division within Supervision) accepted the point in his Report interview that these Preliminary Results suggested that "*…there was a quite fundamental problem with the way that the bank had been run as a whole*", and added "*I don't think that was particularly new*".

(iii) The FSA's appreciation that there was an issue "*with the way that the bank had been run as a whole*" was confirmed (as Mr Adamson accepted in his Report interview) by the email of 13 February 2009 distributed among various senior members of the FSA including Sir Hector Sants (paragraph 92 above). It followed a meeting that Mr Hall (Supervision) had that day with the Finance Director of Lloyds Banking Group. The email ('*Subject: "Lloyds – HBOS losses"*') referred to the Finance Director having made various points about HBOS. While there were significant criticisms of the lending decisions within the Corporate Division, there was also reference to "*the 'woeful' state of controls within HBOS*" and criticism of the "*culture*". The message was that of a poorly run bank(41).

(b) The public interest in an investigation of the "*other equally significant problems*" within the failed bank. This was clearly articulated in the letter from Lord Myners to Sir Hector Sants of 22 September 2009, where he stated: "*It would be wholly unacceptable for any individuals who have materially breached regulatory or other legal requirements to escape the consequences of their actions, and we must send this message clearly once enforcement action has concluded. Clearly, it is for the FSA to determine the scope of its investigations and how to proceed in the light of their findings. I would urge you, however, to be ambitious in scope and as thorough, quick and rigorous as possible*" (paragraph 141 above)(42).

(c) The FSA's specific objective in the case of the failure of HBOS to ensure that the FSA took all enforcement action that could reasonably be taken (paragraph 62 above). While this plainly did not require the FSA to commence every possible investigation, it did mean that the FSA's enforcement action should not ignore the "*other equally significant problems*" within the failed bank, and those potentially culpable in respect of those other problems. This was particularly so given the FSA's strategic priority at this time of bringing more enforcement actions against senior managers (paragraph 44 above).

302. Given that the FSA should have investigated more broadly than Mr Cummings and the Corporate Division alone, the issue is what form that broader investigation should have taken. As stated above, there was no single reasonable enforcement response, but rather there was a range of reasonable enforcement responses. As the investigation should have extended to cover "*the other equally significant problems*" within the failed bank (i.e. those problems of which the FSA was aware), the obvious person whose conduct should have been investigated was the former Group CEO, Mr Hornby. An investigation into Mr Hornby from early 2009 would have enabled the FSA to investigate the range of problems within the failed bank (including the problems in the Treasury and International Divisions, and the reliance on wholesale funding). Furthermore, given the FSA's objective to take such enforcement action as could reasonably be

(41) The email was produced by Mr Hall for internal FSA use, and reflected his understanding of what he had been told by the Finance Director of Lloyds Banking Group.
(42) Although this letter was written some seven months after enforcement action began, it was an articulation by Lord Myners of the public interest in ambitious enforcement action.

taken, a broad investigation of Mr Hornby would, at least potentially, have identified other individuals against whom enforcement action might then have been taken. Given the statutory time limit for bringing disciplinary proceedings (whether against Mr Hornby or against other individuals identified through his investigation), this broader investigation into Mr Hornby should have started no later than early 2009.

303. There can be little doubt that the statutory threshold test for investigating Mr Hornby was met at all times from 1 October 2008 onwards: he was the former Group CEO of a failed bank that had required an enormous injection of public money as a result of its arguable overreliance on wholesale funding(43), and which had experienced, and was continuing to experience, massive losses and impairments in multiple divisions; and he was also, as Group CEO, responsible for the overall control systems operated at HBOS, and was the executive director responsible at Board level for oversight of risk. Indeed, at the early stages of the investigation, the Enforcement investigation case team stated (emphasis added): "*Our theory is that the firm's management should have been aware of the worsening climate by start 2007 and should have looked at its risk appetite at this point and onwards as things changed*" (paragraph 107 above). As the most senior executive director from 2007 until the failure of the bank, the FSA should therefore have regarded Mr Hornby as the most senior member of an executive management that had failed properly to consider the firm's "*risk appetite*". Given that the statutory threshold test for investigating Mr Hornby was met, it was plainly appropriate, given the factors set out in paragraph 301 above, to have investigated him.

304. Two of the Report Interviewees (Sir Hector Sants and Ms Cole) have asserted that it was reasonable for the FSA not to investigate Mr Hornby in late 2008/early 2009, and have advanced three reasons in support of this assertion:

(a) First, they contend that: "*The importance of the bank's collapse should not have overridden all other factors in the exercise of the FSA's discretion to commence an investigation, in particular the perceived merits of the case.*" In fact, as appears from paragraph 301 above, I do not consider that the "*collapse of HBOS*" was an overriding factor as to why Mr Hornby should have been investigated. It was merely a factor which should have been to be taken into account, together with other relevant factors, in considering the range of potential targets for investigation.

(b) Second, they refer to: "*The practical implications of conducting an investigation into Hornby's personal culpability for the bank's collapse*"; and, in particular, they contend that such an investigation would have been a "*monumental task…significantly more demanding*" than the investigation into Mr Cummings, "*would probably have involved a thorough inquiry into the operation of the Board*", and "*would have been one of the most complex and expansive investigations pursued in respect of an individual to date*" conducted despite the "*absence of any direct evidence of his personal culpability*". It is undoubtedly true that an investigation into Mr Hornby would have been a substantial undertaking (as I acknowledge in paragraph 308 below). While that would have been an appropriate factor for the FSA to take into account if it had considered investigating Mr Hornby in late 2008/early 2009 (no such consideration was, in fact, given to investigating Mr Hornby), it would not, in my view, have outweighed the factors supporting an investigation; and it would not have made it reasonable for the FSA to have decided not to investigate Mr Hornby. It is not suggested by Sir Hector Sants and Ms Cole that the FSA would have been unable (in terms of resources) to conduct such an investigation (to the contrary; paragraph 221 above).

(43) On 1 May 2009, the Treasury Select Committee published its report into the banking crisis, and this report recorded Mr Hornby's acceptance that HBOS had been "*over-reliant on wholesale funding*" and that "*the Board should have done more to reduce this reliance*" (paragraph 119 above).

(c) And third, they contend that: "*The public interest in understanding the causes of the collapse was capable of being satisfied outside enforcement action. Indeed, the enforcement division were not best placed to assess the causes of the bank's failure.*" An investigation of Mr Hornby would, however, have enabled the FSA to decide whether or not to bring disciplinary and/or prohibition proceedings against him in relation to the collapse, in a manner which other avenues *"outside enforcement action"* did not.

305. In his Report interview, Mr Jones said: *"…in this sort of failure… I think you always look to that as a natural instinct to – you want to get the person who's ultimately responsible, the most senior person, that's going to get you the biggest impact in the press and give the best impact in the regulated community"*. He also said that a view had already been formed, by early 2009, that Mr Hornby would not be allowed back into the industry: *"It seemed highly unlikely to us that having ruined one bank, or in charge of a bank which had collapsed, that he would have been approved to do the same thing, to take the same role again"*. These comments simply highlight why the FSA's enforcement action should have extended to Mr Hornby from early on in the enforcement process.

306. The next issue is whether it was unreasonable for the FSA not to have commenced enforcement action against additional individuals in early 2009 (i.e. beyond Mr Cummings and Mr Hornby) and, if so, which additional individuals should have been investigated. In considering this issue, there are three factors to bear in mind. First, an assessment of the reasonableness of the FSA's enforcement response in early 2009 must be conducted on the basis of what the FSA knew at the time, and must avoid being influenced by information obtained at a later time and, in particular, information known today. For example, the PCBS Report dated 5 April 2013 ('*An accident waiting to happen: The failure of HBOS*') contains significant criticisms of Mr Crosby. These criticisms were made at the end of a process of detailed examination by the PCBS. It does not necessarily follow that, in early 2009, the FSA should have identified Mr Crosby (who had left the bank in July 2006) as a potential target for investigation.

307. Second, the regulatory regime gave the FSA, as the regulator, a discretion as to which subjects to select for investigation, and did not require the FSA to bring enforcement action against all individuals in respect of whom the statutory threshold test for conducting an investigation was met. It follows that, even if the statutory threshold test for investigating all members of the Board at the date of failure (plus the CEO of the Treasury Division) was met, the FSA was not required to investigate all of those individuals. Once the threshold test for an investigation was met, the FSA was entitled to select the subject(s) for investigation after considering "*all relevant circumstances*" (paragraphs 42 and 43 above).

308. Third, the "*relevant circumstances*" which the FSA was entitled to taken into account included the resourcing commitments that would be required (in terms of money, time and personnel) in bringing enforcement action. In this regard, there is no doubt that both Supervision and Enforcement were under very considerable pressure in early 2009 (including with the three Project Rainbow investigations), and that any further investigations (beyond Mr Cummings and Mr Hornby) would have been a substantial additional undertaking. The estimated cost of the investigation of Mr Cummings was over £2 million in external fees; and the investigation involved continuous work for around two years on the part of as many as 24 people in Enforcement (numbers varied at different stages of the investigation, and reached 24 people during the disclosure stage) – in addition to the involvement of multiple E&Y personnel(44). The cost of investigating Mr Hornby would also have been substantial, and would presumably have involved at least the same number of people (both internal and external). Indeed, given the

(44) It appears that the actual cost of the enforcement action against Mr Cummings was considerably greater than the estimate. In the FSA document entitled '*Written evidence from the Financial Services Authority*' dated 18 January 2013, provided to the PCBS (also referred to in footnote 12 above), the FSA was asked (Question 22) to "*give us an indication of the internal (for example, FSA employees) and external (for example, legal fees) costs for bringing a case such as the ones involving John Pottage and Peter Cummings.*" In response to this, the FSA stated that: "*In the Peter Cummings case, approximately £1.4 million was spent on internal case costs and approximately £4 million on external fees.*"

wider reach of his responsibilities, it may well have been a more expensive investigation and more personnel-intensive than the investigation of Mr Cummings. Any further investigations beyond these two individuals would, therefore, have involved very significant additional commitments for the FSA at a time when it was clearly under great pressure. Furthermore, the cost (in terms of money, time and personnel) of bringing contested disciplinary or prohibition proceedings to the RDC and then to the Upper Tribunal would also have been substantial.

309. It is, therefore, important to bear in mind the point made by Sir Hector Sants in his Report interview: "*the FSA was stretched almost to breaking point in terms of its resources in this period*". Indeed, a number of the other Report interviewees made it clear that Enforcement would have found it extremely difficult to cope with any substantial additional investigation beyond that of Mr Cummings. There are also a number of contemporaneous documents in which Mr Walker and Mr Jones expressed concern at the stretched resources of the Enforcement team (for example, paragraphs 134, 139, 155 and 190 above). Therefore, although I have concluded that the FSA should have investigated Mr Hornby from early 2009, I am mindful of the fact that any additional substantial investigation (beyond Mr Cummings and Mr Hornby) would have been extremely challenging for the FSA at this time(45).

310. On balance, I consider that the minimum reasonable enforcement response in early 2009 was an investigation of Mr Cummings (in relation to the Corporate Division) and also of Mr Hornby (more broadly). If that course had been adopted, the FSA would have been able to investigate the various significant problems in the failed bank, and not just those in the Corporate Division; and this course of action would have involved investigating both the former Group CEO of the failed bank, and also the former CEO of the Division responsible for generating its most significant losses (in absolute terms). This course of action (particularly through the investigation of Mr Hornby) might also have enabled the FSA to identify other former senior managers whose potential culpability made them appropriate subjects for enforcement action. However, given the statutory time limit, disciplinary action against such additional individuals required that any investigation into Mr Hornby had to be commenced by early 2009, and had to be conducted with real expedition. I do not, therefore, consider that the FSA acted unreasonably, in early 2009, in not investigating other individuals beyond Mr Cummings and Mr Hornby.

311. It follows that I do not consider that it was unreasonable for the FSA not to have investigated Lord Stevenson from early 2009. As explained above, so long as there had been an investigation of Mr Hornby in addition to Mr Cummings, that would have secured the wider consideration of the issues at the failed bank which was necessary, and potentially would have provided an adequate investigative foothold for commencing further enforcement action against individuals other than Mr Cummings and Mr Hornby in due course if considered appropriate.

312. It was, however, clearly unreasonable for the FSA to have failed, as it did, even to give proper consideration as to whether or not to investigate Lord Stevenson, given that the statutory threshold test for investigating him was clearly met (paragraph 293b above). It is extremely difficult to speculate as to what decision the FSA would actually have reached if it had adopted a proper decision-making process: as set out above, the FSA could reasonably have decided on a number of different courses. Clearly Lord Stevenson might have been placed under investigation had there ever been a proper consideration of his position.

313. Other points to note about the position of Lord Stevenson are as follows:

(45) There was a tension between the FSA's stated objective of taking all enforcement action that could reasonably be taken and the fact that it was stretched "*almost to breaking point*" at this time. This may reflect the fact that, while wanting to bring all appropriate enforcement action, the FSA did not have enough experienced people working in Enforcement to do so. If it had decided to conduct any further investigations arising from the failure of HBOS, the FSA would therefore probably have had to re-allocate employees then working on other investigations and/or to utilise external resources such as E&Y.

(a) While the PCBS Report ('*An accident waiting to happen: The failure of HBOS*') reached certain conclusions in relation to his conduct as Chairman of the Board, the FSA was not in a position to reach such conclusions in early 2009, and indeed appears to have had limited information about his particular conduct at that time (and indeed thereafter). Thus, although it could have investigated him at that time, the FSA had no reason to conclude that he bore particular culpability in relation to the failed bank.

(b) Beyond Mr Hornby and Mr Cummings, there were various potential subjects whom the FSA could reasonably have investigated in early 2009, of whom Lord Stevenson was one. In particular, the FSA could have investigated the members of the Board at the date of failure, plus the CEO of the Treasury Division at that date (who was not a member of the Board). There were, however, no particular factors pointing to an investigation of Lord Stevenson in early 2009 rather than, for example, an investigation of the CEOs of the Treasury and International Divisions at the date of failure.

(c) Indeed, if the FSA ought to have investigated beyond Mr Cummings and Mr Hornby, a reasonable conclusion would have been that the more obvious additional targets were the CEOs of the Treasury and International Divisions at the date of failure, given the substantial losses/impairments generated by those divisions. The FSA, therefore, could reasonably have concluded, on the basis of its knowledge in early 2009, that there were at least four targets for enforcement action ahead of Lord Stevenson i.e. Mr Cummings, Mr Hornby, Mr Matthew (former CEO of the International Division) and Mr Mackay (former CEO of the Treasury Division)(46).

(d) Indeed, the same point could also be made about the Group Risk Director and/or the Group Finance Director at the date of failure i.e. Mr Hickman and Mr Ellis. Again, the FSA could reasonably have concluded, on the basis of its knowledge in early 2009, that these individuals were more obvious targets for investigation than Lord Stevenson.

314. It also follows that I do not consider that it was unreasonable for the FSA not to have investigated Mr Crosby from early 2009. Mr Crosby had left HBOS in July 2006 and, when the FSA was deciding upon what enforcement action to take in early 2009, there was, as far as the FSA was aware, little if any information indicating potential personal culpability on the part of Mr Crosby. While, arguably, the statutory threshold test for investigating him was nevertheless met, a reasonable regulator would have been perfectly entitled to conclude, in early 2009, that (beyond Mr Cummings and Mr Hornby) there were a number of people whom it would have been more appropriate to investigate than Mr Crosby, the most obvious examples being the former CEOs of the Treasury and International Divisions.

315. For these reasons, I have concluded that the decision in early 2009 to investigate Mr Cummings was, in itself, a reasonable one; but that the FSA should also have investigated Mr Hornby and that its failure to do so was not reasonable. I do not, however, consider that the FSA acted unreasonably in not commencing investigations into other former senior managers (i.e. beyond Mr Cummings and Mr Hornby).

316. Finally, I do not consider that the failure to investigate the firm from the outset (i.e. from early 2009) was unreasonable given, in particular, that (1) the FSA was focussing at this time on investigating senior individuals, and (2) there were exceptional circumstances which justified not seeking a financial penalty against the firm (paragraph 225 above). If the FSA had decided that it was not going to commit substantial resources to enforcement action against a firm where the

(46) Indeed, Mr Matthew, in addition to being the CEO of the International Division, was also the Board member to whom Mr Mackay, CEO of the Treasury Division, reported from March 2007 until the failure of the bank. He was, therefore, the Board director responsible for the Treasury Division, as well as being the Board director responsible for the International Division. Furthermore, he was authorised to sign all deals (including those in the Corporate Division) of £250 million and above (although the limit was lowered in 2008), and he did sign off a number of loans made by the Corporate Division.

only likely outcome was a public censure (as opposed to a financial penalty), such a decision would have been a reasonable one[47].

D.4 The failure properly to consider the scope of the investigation throughout 2009

317. I consider that, in the period between 26 February 2009 and the end of 2009, the FSA failed properly to consider the scope of the ongoing investigation and, in particular, failed to consider whether or not to extend the investigation to other former senior managers of HBOS. The facts relevant to this conclusion are set out in section C(2) above.

318. The FSA, having started the investigation, rightly regarded it as important to review the scope of the ongoing investigation in the light of further information (whether obtained during the investigation or otherwise). This was the FSA's general approach once investigations had begun (paragraph 47 above). It was, however, particularly important that the FSA was vigilant in monitoring the scope of this investigation given that (1) the investigation was limited to Mr Cummings and the Corporate Division, and did not cover the other known problems with the failed bank; (2) the investigation of Mr Cummings was regarded as a "*starting point*"; (3) the FSA's objective was to take enforcement action where such action could reasonably be taken; and (4) the statutory time limit (initially two years) meant that any new investigations would need to be brought expeditiously.

319. The fact that the FSA appreciated the importance of monitoring the scope of the ongoing investigation in this way is evident from the contemporaneous communications. For example, Mr Walker stated in his email of 23 April 2009 to Ms Cole: "*If we identify problems in specific business divisions we can then take a decision on whether it is appropriate to broaden the scope*" (paragraph 116 above). As Sir Hector Sants told Lord Myners in his letter of 1 September 2009: "*In respect of the other firms covered by these investigations we will, once we have concluded the work, consider the implications of our findings in respect of other executives including the CEOs and the Boards"* (paragraph 138 above).

320. This appreciation of the importance of monitoring the scope of the ongoing investigation was also confirmed by a number of the Report interviewees. For example, Sir Hector Sants said that he expected that "*…if new information came to light…there would be a constant reappraisal or real time assessment of that information as to whether a course of action should be changed or new actions taken*". Mr Walker made the point that he would expect his Enforcement investigation case team "*to keep under review the scope*" as "*new evidence was coming in*" as a result of the investigation; and that he would also expect Supervision to keep the scope under review in the light of any new material coming into Supervision.

321. However, the FSA's internal procedures were inadequate in this regard. In his Report interview, Mr Walker was asked whether there was a formal procedure whereby either Supervision or Enforcement was allocated responsibility for considering whether or not to expand the scope of an existing investigation. It was apparent from his answer that no such formal procedure existed.

322. Although an Enforcement investigation case team was meant to conduct regular reviews in relation to an ongoing investigation (initially at thirty and sixty days, and then at six months), the process was informal and appears to have involved email communication, at a relatively general level, between the head of the Enforcement investigation case team (here Mr Jones) and the relevant Project Sponsor (here Mr Walker). In the case of the investigation of Mr Cummings,

(47) What was not reasonable (as set out in paragraph 294 above) was the decision-making process whereby no proper consideration was given to an investigation of the firm.

there does not appear to have been a thirty day review (which would have been in around late March). This was understandable given that the tendering process (whereby the accountants for each of the three Project Rainbow investigations were selected) was still being conducted at the thirty day review point, and no investigation had properly begun.

323. There was a sixty day review, which was contained in the email exchange between Mr Jones and Mr Walker on 28 April 2009 (paragraph 117 above). In his email, Mr Jones gave a brief account of the state of the investigation, and fairly made the point that almost all of the Enforcement investigation case team's time had been taken up in the tendering process which was about to conclude with the appointment of E&Y. He concluded that: "*…the obvious recommendation is that we should continue [i.e. with the investigation] with a further review point at mid-August once we have absorbed the information contained over the next three months.*" Mr Walker responded by email: "*Thank you for this. I agree.*" In fact, E&Y had not finished its work by mid-August, and it does not appear that a review took place at that time. It is unclear when, and if, a subsequent review took place.

324. Perhaps more significantly, there was no formal process whereby Supervision and Enforcement jointly reviewed the scope of an ongoing investigation. This meant that there was a real risk, particularly at a time when the FSA was under considerable pressure, that information known to one department might not be passed over to the other department. Indeed, it was apparent from the Report interviews that there was some degree of confusion as to where responsibility lay for initiating and driving forward a consideration of the scope of an existing investigation. Some interviewees (such as Mr Walker and Ms Cole) thought that the possible expansion of the scope of an investigation was a matter for Supervision to raise with Enforcement; others (such as Mr Taylor) thought it was a matter for Enforcement to raise with Supervision; and others (such as Sir Hector Sants) thought it was a matter which would be raised by a dialogue between Supervision and Enforcement.

325. The upshot was that the FSA failed, in the period from 26 February 2009 up to the end of 2009, to give any proper consideration to extending the investigation into other former senior managers. Although Enforcement did, on a fairly regular basis, make clear that it would consider extending the scope in due course (e.g. once E&Y had completed its work), there was not in this period any actual consideration, either within Enforcement or jointly between Enforcement and Supervision, as to whether or not it was appropriate to extend the scope of the investigation. Given the statutory time limit for bringing disciplinary proceedings was running down during this period, this was a significant failure in the FSA's decision-making process.

326. There were, as set out in section C(2) above, a number of occasions during this period when the FSA should have considered whether or not to investigate other former senior managers. In particular, the FSA should have considered investigating, among others, Mr Ellis (former Group Finance Director), Mr Matthew (former CEO of the International Division), Mr Mackay (former CEO of the Treasury Division), Mr Hornby (former Group CEO) and Lord Stevenson (former Chairman). Yet it appears not to have considered investigating any of these individuals during this period.

327. Mr Walker said, in his Report interview, that he was surprised that there were no conversations between Supervision and Enforcement after February 2009 regarding the significant losses in other divisions of the failed bank. He also said that, if he had known about the losses, then he would have tasked the Supervision team with finding out the reason for the losses so that they could consider the question: "*…is there a parallel issue to corporate?*" There was, accordingly, a failure to ensure that Mr Walker, the Project Sponsor responsible for the investigation of Mr Cummings, was kept up to date as to the ongoing financial performance of the bank, and in particular as to the losses outside the Corporate Division (particularly those in the International Division), despite the fact that Supervision was clearly aware of them and that they quickly became a matter of public record.

328. Indeed, Ms Williams (who was no longer supervising HBOS, but yet took the time to do so) expressly raised the question, on 29 June 2009, as to whether Mr Matthew should be investigated. Her email (sent to three other people in Supervision, namely Mr Hall, Mr Johnson and Ms Thomas) stated that: "*HBOS's international wholesale/corporate businesses are performing as poorly as the UK business formerly headed by Peter Cummings…Given this degree of overlap and in view of our decision to refer [Mr Cummings] to enforcement, I wondered if you had any plans to do the same for Matthews…*" (paragraph 129 above). This email does not appear to have been discussed among its recipients, and neither the email nor its contents were passed on to Enforcement. As a result, no consideration was given to extending the scope of the investigation to Mr Matthew. Plainly, there was a material deficiency in the FSA's internal procedures as a result of which significant information known to Supervision never reached Enforcement, and there was accordingly no joint consideration given by Supervision and Enforcement as to whether or not to extend the scope of the investigation to Mr Matthew.

329. One can only speculate as to what the FSA would have done if it had properly considered extending the scope of the investigation to, for example, Mr Matthew. However, as a result of this failure by the FSA, an opportunity to investigate someone who was potentially culpable in respect of the problems within HBOS was lost. It is now almost certainly too late to bring disciplinary proceedings against Mr Matthew, and against the other individuals who should also have been considered in this period. However, it is not too late for the FSA now to consider whether to commence further investigations with a view to prohibition proceedings (section D(9) below)[48].

D.5 The decision in March 2010 not to investigate Mr Hornby

330. In early 2010, the FSA considered, for the first time, whether or not to investigate Mr Hornby. The proposed investigation was limited to Mr Hornby's oversight of the Corporate Division, i.e. it was not the broader investigation that should have been commenced by early 2009. In March 2010, having concluded that the statutory threshold test for investigating Mr Hornby was met, the FSA nevertheless decided not to investigate him. I consider that this decision was unreasonable, in terms both of its substantive content and the decision-making process. The facts relevant to this conclusion are set out in section C(3) above.

331. Having concluded, reasonably, that the statutory threshold test for investigating Mr Hornby was met, the FSA should have decided that, in all the circumstances, it was appropriate to investigate him even if only in relation to his oversight of the Corporate Division. The particular factors which should have given rise to this conclusion were: (1) the public interest in investigating the person who was Group CEO of a systemically important bank at the date of its failure, particularly given his responsibility for the overall control systems operated at the failed bank; (2) the FSA's stated objectives of ensuring that it took all enforcement action that could reasonably be taken, and of bringing action against senior managers – Mr Hornby being "*the most senior culpable manager*" to use the phrase in the Enforcement memorandum of February 2010 (paragraph 155 above); and (3) the fact that many, if not all, of the referral criteria in the ERD signed off for Mr Cummings applied with equal force to Mr Hornby (the ERD is at annexe 4). The factors set out in paragraphs 291 and 301 above are of obvious relevance in this context also.

(48) The reason why I have not concluded that the FSA should actually have started an investigation into any of these individuals after 26 February 2009 is because such a conclusion involves too much speculation. For example: on the assumption that the FSA had investigated both Mr Cummings and Mr Hornby from the outset (as it should have done), it might have decided (had it conducted a proper decision-making process) that it would not investigate any of these other individuals, because (1) it would have been too challenging to conduct yet further investigations given the resources being taken up with the enforcement actions against Mr Hornby and Mr Cummings, and (2) the public message and strategic priority of actions against SIFs was adequately met without yet further investigations. That might have been a reasonable decision in the circumstances.

332. It appears (from the Report interviews) that the key factor that drove the decision not to investigate Mr Hornby was, as Ms Cole put it in her Report interview, that "*…they [i.e. Enforcement] didn't feel they could guarantee bringing a case against Hornby that would succeed and that was how I was testing these things*". It, therefore, appears that because Enforcement could not be certain of winning disciplinary proceedings against Mr Hornby, the decision was taken not to investigate him. This was a misguided approach in that it placed excessive weight on a view of the prospects of success formed at such an early stage(49). Indeed, the purpose of an investigation was to ascertain whether or not there was material to justify bringing disciplinary proceedings. As was stated in a paper produced by Enforcement on 23 May 2012 (i.e. over two years later), when considering other possible investigations in relation to the oversight of the Corporate Division (paragraph 262 above): "*We will not, however, be able to establish the strength of any likely case without an enforcement investigation or until any report into why HBOS failed.*" Here, Enforcement rightly acknowledged that, until an investigation had taken place, the strength of any likely disciplinary proceedings could not be known.

333. Furthermore, in addition to the decision not being a reasonable one, the decision-making process was highly unsatisfactory. On the basis of the available documents, it is not possible to determine who in fact took the decision, when it was taken, how it was taken, what were the factors taken into account, or for what precise reasons it was decided not to investigate. While the paper produced for ExCo dated 30 March 2010 referred to a "*careful consideration*" (paragraph 163 above), there is no documentary evidence recording or reflecting any such careful consideration. The Report interviewees were not consistent in their recollection of any of these critical matters, to the point that it remains unclear, even after the interviews, who actually took the decision not to investigate Mr Hornby.

D.6 The decision in April 2011 to investigate BoS

334. I consider that the decision to investigate the firm (BoS), made by the FSA in April 2011, was a reasonable one. In particular, the statutory threshold test for investigating the firm in relation to its management and control of the Corporate Division was clearly met; and, in "*all the circumstances*", it was reasonable to conclude that it was appropriate to investigate BoS: the apprehended breaches were clearly serious ones, and had resulted in, or contributed to, substantial losses in the Corporate Division. Indeed, in the FSA's estimation, those breaches would have justified what would at that point have been the largest fine ever imposed by the FSA.

335. However, as appears from the circumstances relating to this decision (as set out in section C(5) above), it was an unusual decision in that it was made some two years after the start of the investigation of Mr Cummings; it was made in the light of the concerns, raised by the FSA's legal reviewer of the proposed case against Mr Cummings, as to potential legal weakness of that case and was therefore a consequence of the FSA seeking to strengthen that case (by adding a '*knowingly concerned*' allegation); it involved bringing enforcement action against the firm in circumstances where Lloyds Banking Group had been co-operating throughout the course of the investigation into Mr Cummings, and had never been told about the possibility of such an investigation; and it was not anticipated that there would be, and there was not in fact, any substantive investigation into the firm (such investigation having already been conducted in relation to Mr Cummings). The decision to investigate the firm did not expand the scope of the investigation beyond consideration of the problems in the Corporate Division, but simply analysed the information obtained in the existing investigation of Mr Cummings in the context

(49) By this time, the investigation into Mr Cummings had been ongoing for over a year. It follows that Enforcement had obtained some, albeit limited, insight into Mr Hornby's conduct by this time. However, Enforcement had not conducted any investigation into the conduct of Mr Hornby (still less a formal and/or thorough investigation); and it was not, therefore, in a position to assess whether any disciplinary proceedings would have succeeded in the event that it decided to conduct such an investigation.

of the firm. These unusual factors did not, however, make the decision to investigate the firm an unreasonable one.

336. The fact that an investigation into the firm was first given proper consideration some two years after the start of the investigation of Mr Cummings does, however, highlight the flawed nature of FSA's initial decision-making in the period up to 26 February 2009. The main deficiency was that this was the first time that the FSA appears to have considered whether or not the statutory threshold test for investigating the firm was met, even though this should plainly have been considered prior to 26 February 2009 (paragraph 294 above). A further deficiency was that the FSA took the view at this time that an advantage of investigating and then bringing disciplinary action against the firm was that it might reassure the RDC that Mr Cummings was not being treated as a scapegoat (paragraph 194 above). However, any concern that Mr Cummings might be viewed as a scapegoat should have been addressed prior to the referral of Mr Cummings, alone, for investigation. While the issue of being seen to treat one person as a scapegoat had been raised in an email of 22 December 2008, it had never been properly addressed (paragraph 74 above).

D.7 The decisions to compromise the proceedings against Mr Cummings and BoS

337. I consider that the FSA's decisions, in March and September 2012 respectively, to compromise the disciplinary and/or prohibition proceedings brought against BoS and Mr Cummings were reasonable. Those decisions reflected a reasonable judgment as to what was realistically achievable by way of penalty in each case and the inherent litigation risks. The facts relevant to this conclusion are set out in section C(6) above.

338. As a result of these decisions, the FSA achieved successful public outcomes and delivered a public message regarding the responsibilities of SIFs. If Mr Cummings had appealed to the Upper Tribunal there could be no guarantee that the FSA would achieve a successful outcome. Indeed, in the only example of a similar type of disciplinary case the SIF successfully appealed to the Upper Tribunal(50). While the £500,000 financial penalty that was agreed with Mr Cummings was less than that proposed by the RDC in the Decision Notice (£800,000), it was nevertheless a large financial penalty for an individual and contributed to the FSA's deterrence message. In relation to the settlement with BoS, it was reasonable not to impose a financial penalty given the exceptional circumstances in which HBOS had been rescued by Lloyds Banking Group with UK Government support (paragraphs 224 and 225 above).

D.8 The FSA's consideration in mid-2012 of investigating any other former senior managers; and its consideration of starting an HBOS report

339. In mid-2012, the FSA's ExCo was considering whether the FSA should investigate any other former senior managers of HBOS, and the issue arose as to whether it would be better to defer such consideration until after the production of a final HBOS report. As stated above (paragraph 266), insofar as a decision was made by ExCo on this important issue, the poorly drafted ExCo minutes do not properly record any such decision. That is an unsatisfactory situation.

340. A further issue being considered by the FSA's ExCo in mid-2012 was whether or not the FSA should begin work on an HBOS report while the enforcement action against Mr Cummings was continuing. Again (paragraph 266 above), insofar as a decision was made on this important issue, any such decision is not properly recorded in the poorly drafted ExCo minutes. This is an

(50) See John Pottage v FSA [2012] UKUT B6 (TCC) (20 April 2012).

unsatisfactory situation. A further element of uncertainty is whether or not ExCo, in its deliberations, took into account the potential 'risk' identified by Enforcement (paragraphs 245 and 264 above) that working on an HBOS report might undermine the enforcement action against Mr Cummings, i.e. because such work might produce disclosable material which would support Mr Cummings' defence and undermine the FSA's case. While it may have been appropriate for Enforcement to raise this as a potential risk of conducting these parallel activities, it would not have been a reasonable justification for a decision not to start work on an HBOS report. It would, in effect, have amounted to a decision not to obtain a detailed understanding of the causes of the failure of HBOS in case this assisted Mr Cummings' defence. However, due to the poor quality of the ExCo minutes, it is unclear as to how ExCo evaluated this factor. This too is unsatisfactory.

D.9 Whether the FCA should now consider further investigations

341. The PCBS Report ('*An accident waiting to happen: The failure of HBOS*') concluded, in paragraph 135, as follows: "*In the view of this Commission, it is right and proper that primary responsibility for the downfall of HBOS should rest with Sir James Crosby, architect of the strategy that set the course for disaster, with Andy Hornby, who proved unable or unwilling to change course, and Lord Stevenson, who presided over the bank's board from its birth to its death…Apart from allowing their Approved Persons status at HBOS to lapse as their posts were wound up, the FSA appears to have taken no steps to establish whether they are fit and proper persons to hold Approved Persons status elsewhere in the UK financial sector. The Commission therefore considers that the FSA should examine, as part of its forthcoming review of the failure of HBOS, whether these three individuals should be barred from undertaking any role in the financial sector.*" And paragraph 141(h) stated that the FSA, when producing its report on the failure of HBOS, should consider "*whether, rather than having their Approved Status simply lapse, Lord Stevenson, Sir James Crosby and Andy Hornby (and anyone else presiding over a similar failure in the future) should be prohibited from holding a position at any regulated entity in the financial sector.*"

342. In the light of the PCBS Report, the Terms of Reference invite me to offer an opinion "*as to whether the regulators should consider afresh whether any former members of HBOS's senior management should be subject to an investigation with a view to prohibition proceedings*" (emphasis added). This is not confined to a consideration of the three individuals referred to in the PCBS Report.

343. In my view, the FCA and/or the PRA should, indeed, now "*consider afresh whether any former members of HBOS's senior management should be subject to an investigation with a view to prohibition proceedings*" (i.e. other than Mr Cummings). Following the failure of HBOS, the FSA should have conducted a decision-making process which involved a proper consideration of the range of potential subjects for investigation. However, (as explained above) the decision-making process, in late 2008 and early 2009, was materially deficient, and there was no such proper consideration given by the FSA. Indeed, in his Report interview, Mr Adamson (who was, until recently, Director of Supervision at the FCA) stated that "*the people most culpable were let off*"; that in his view those people were the former Group CEO and Chairman (i.e. Mr Hornby and Lord Stevenson); and he fairly accepted that "*there was something unsatisfactory in the [initial] referral decision-making process whereby these people were not even considered*" for investigation.

344. In these circumstances, it is, in my view, appropriate that the FCA and/or the PRA should now take the opportunity to give proper consideration to the investigation of individuals other than Mr Cummings, and thereby do that which their predecessor, the FSA, failed to do. There is plainly a public interest in the FCA and/or the PRA giving proper consideration as to whether to

investigate any other former members of HBOS's senior management in the light of the failure of this systemically important bank.

345. I should emphasise that, although I have read a pre-maxwellisation draft HBOS report, my conclusion that the FCA and/or the PRA should consider afresh whether to commence other investigations is not based on the content of that draft report, but is based on my view as to the deficiencies in the FSA's decision-making process in late 2008 and early 2009 (as identified above) and the fact that there is now an opportunity to remedy those deficiencies (at least as regards possible prohibition proceedings). If the FCA and/or PRA act upon this recommendation and hereafter give proper consideration to this issue, it is a matter for the FCA and/or PRA, acting as reasonable regulators, to decide whether to commence any such investigation. In doing so, the regulators will need to consider all relevant information available to them at the time of their consideration. It is no part of the Terms of Reference that I should offer any view on this issue.

D.10 Why were mistakes made?

346. In the light of my overall conclusion that the scope of the FSA's enforcement investigations in relation to the failure of HBOS was not reasonable, and my assessment that a number of mistakes were made, I set out below some of the reasons why it appears that mistakes were made. These reasons became apparent during the Report interviews conducted with 14 former FSA employees.

347. First, the regulatory scheme made it difficult to bring successful enforcement action against senior bankers. Although the statutory threshold test for conducting an investigation was a low one ("*circumstances suggesting*" that a person "*may be guilty of misconduct*"), the regulatory scheme required the FSA to establish '*personal culpability*' if it was to succeed in disciplinary proceedings brought against an individual for '*misconduct*'. There can be little doubt that establishing '*personal culpability*' was a difficult task in the context of the failure of a substantial multi-divisional corporate entity such as HBOS, where strategy was frequently the result of collective decision-making by a Board over an extended period of time. This is illustrated in the context of the FSA's consideration in early 2010 of an investigation of Mr Hornby in relation to his oversight of the Corporate Division: Enforcement (prior to the decision being made) said that it would be difficult to separate Mr Hornby's conduct from that of the Group Risk Director and/or the Group Finance Director (paragraph 155 above). Indeed, a number of Report interviewees emphasised Enforcement's general view that it was difficult to win '*misconduct*' cases brought against senior managers; and Mr Jones said that the general view within the FSA at the time was that "*enforcement against big bankers had become virtually impossible*". The regulatory scheme did not, therefore, encourage an ambitious approach to the bringing of enforcement action in the context of a failed bank.

348. Second, as a result of the need to establish '*personal culpability*' in '*misconduct*' cases, the FSA, when considering whether or not to conduct an investigation of an individual, would attempt to assess the likelihood of winning subsequent disciplinary proceedings against that individual i.e. such disciplinary proceedings as would be brought after an investigation had been concluded. The problem with this approach was the difficulty in accurately evaluating the prospects of success in disciplinary proceedings before an investigation had even begun. This approach, therefore, had a tendency to discourage the FSA from starting investigations even though the threshold test for investigating was met and even though the public importance of investigating was high. Indeed, this approach appears to have been the reason why, in March 2010 the decision was taken not to investigate Mr Hornby (insofar as any reason for the decision can be discerned). In her Report interview, Ms Cole said that Enforcement "*didn't feel they could*

guarantee bringing a case against Hornby that would succeed and that was how I was testing these things".

349. Third, the FSA's internal procedures as to how decisions were to be made for the referral of subjects for investigation were inadequate. There was, in particular, no formal procedure whereby the referring department (in this case Supervision) and Enforcement were required to identify and record in writing (1) the range of potential subjects, both individuals and firm, in respect of whom the statutory threshold test for conducting an investigation was met, and (2) if the test was met, what were the reasons for investigating some subjects and not investigating others. If such a procedure had existed, it is likely that the FSA would, from the outset, have considered a broader range of investigations than an investigation of Mr Cummings alone, and in particular it is likely that it would have concluded that the statutory threshold test for investigating both the bank and the members of the Board at the date of the failure of the bank (as well as Mr Mackay) was met. It would then have had to decide why it was not going to investigate either the bank or any other such former senior managers. This is addressed in the 'Recommendations' below (Recommendation 1).

350. Fourth, the FSA's internal procedures relating to the monitoring of the scope of ongoing investigations were inadequate. There was, in particular, no formal procedure whereby, once an investigation had begun, the referring department (here Supervision) and Enforcement would consider together, at regular meetings, whether further information had come to light which indicated that there were other subjects in respect of whom the statutory threshold test for conducting an investigating was met. Instead, there was considerable confusion between Supervision and Enforcement as to who was responsible for monitoring the scope of the ongoing investigation into Mr Cummings, with the result that important opportunities to consider expanding the investigation were missed. If a formal procedure had existed, it is likely that the FSA would have considered investigating other former senior managers in the period during the course of 2009. This is addressed in the 'Recommendations' below (Recommendation 2).

351. Fifth, from at least 2008 onwards, the FSA (including both Supervision and Enforcement) was under enormous pressure as a result of the global financial crisis and the UK banking crisis: as Sir Hector Sants said: "*the FSA was stretched almost to breaking point in terms of its resources in this period*". These exceptional circumstances must provide some explanation as to why mistakes were made:

(a) In the case of Supervision, its priority in this period was ensuring financial stability going forward. In a short written statement produced by Ms Thomas (Supervision) prior to her Report interview, she said: "*Financial stability was the supervision team's utmost priority, with our primary focus on mitigating the forward looking prudential risks, given the ongoing financial crisis and the deteriorating macro-economy. The historical position was covered, but we had very limited capacity and enforcement issues/consideration accounted for at most five per cent of the supervisory team's time during this period (and probably less than one per cent of mine).*" And, in her Report interview, Ms Williams said: "*So we were still facing a day-to-day sort of survival game, and we were also in the parallel running some contingency planning just in case the Lloyds bid didn't go through…So there was a lot going on, and Enforcement was one thing amongst many, but actually stabilising and getting funding into HBOS was the number one priority because they were losing huge deposits even after the Lloyds bid was made*". Mr Hall, in his Report interview, referred to the "*exhaustion levels*" within Supervision in 2008 and 2009.

(b) In the case of Enforcement, in February 2009 there were 209 ongoing enforcement investigations being conducted by a total of 282 employees; and by February 2010, the

figures were 190 investigations and 369 employees[51]. Even though many of these investigations would have been relatively small, there is no doubt that Enforcement, like Supervision, was under very considerable pressure.

352. Despite the criticisms I have made of the FSA in this Report, in fairness to those Report interviewees working at the FSA at the time, the impression I formed was that they were committed and hard-working.

353. Sixth, there appears to have been inadequate communication between Sir Hector Sants and Enforcement as to the enforcement action being taken in relation to the failure of HBOS. In circumstances where Sir Hector had "*set the tone*" by making clear *"that any enforcement action that could be taken here should be taken"* (this being "*because Parliament and the public rightly would expect the FSA to do it*"), it is surprising that Sir Hector was unaware that Enforcement was adopting a different approach to enforcement action, i.e. that it would not investigate an individual unless it was already satisfied that there was a good chance of winning a disciplinary case against that individual. Indeed, although Sir Hector was told in March 2010 that enforcement action was not going to be commenced against Mr Hornby, he was not told that Enforcement considered that the statutory threshold test for investigating Mr Hornby was met.

354. The inadequate communication between Sir Hector Sants and Enforcement was further illustrated by the fact that in April 2012, when he saw the paper prepared for ExCo by Enforcement dealing with possible further investigations against senior managers other than Mr Cummings (paragraphs 250 to 257 above), Sir Hector thought that Enforcement had considered whether to investigate Mr Hornby not only in relation to his oversight of the Corporate Division but also "*on wider matters*". In fact, no such consideration had ever been given to a broader investigation of Mr Hornby.

(51) The total figure, in February 2009, for the Enforcement and Financial Crime Division was 353 employees, with 282 of those working with the enforcement section of that division; and, for February 2010, the total figures were 444 and 369 respectively.

E. Recommendations

355. The Terms of Reference invite me to make recommendations arising out of my findings. I have, therefore, set out below four recommendations. The FCA and the PRA have inherited the FSA's enforcement powers and therefore my recommendations are addressed to both of those regulators (referred to below as *'the Regulators'*).

Recommendation 1: Pre-referral decision-making

356. Before making a referral in connection with a particular set of events, the Regulators should identify each firm or individual in respect of whom the statutory threshold test for conducting an investigation is met in respect of those events. The Regulators should create a record of the potential subjects of investigation so identified.

357. Having identified all potential subjects of an enforcement investigation, the Regulators should then decide, by considering the referral criteria, which, if any, of the potential subjects should, in fact, become the subject of an investigation. The Regulators should record the reasons why each potential subject is either being referred, or is not being referred, for investigation.

358. An identified individual (at an appropriate level of seniority) should be made responsible for this pre-referral decision-making process (i.e. from the point in time at which a referral is being considered) and, in particular, for determining the subject(s) for referral and the scope of that referral ('the Decision-Maker').

Recommendation 2: Ongoing dialogue between Enforcement and Supervision during an investigation

359. Following a referral to Enforcement, the Decision-Maker should meet regularly with a representative of the referring department (i.e. Supervision) and a representative of the Enforcement investigation case team. During that meeting the appropriateness of the scope of the ongoing investigation should be discussed. In particular, consideration should be given to (1) any matters that have arisen that might require the scope of the investigation to be reconsidered, and (2) whether there are other subjects in respect of whom the statutory threshold test for conducting an investigation are met and, if so, which potential subjects should be investigated by reference to the referral criteria.

360. Such meetings should take place at least quarterly and should be recorded; and a record should be made of the reasons why any new potential subject is either being referred, or is not being referred, for investigation.

Recommendation 3: Informing the subject of an investigation about the matters under investigation

361. The Memorandum of Appointment of Investigators ('MAI') issued to Mr Cummings did not communicate in any real sense the matters the FSA intended to investigate (paragraph 109 above, and annexe 5 where the MAI is attached). By the time the FSA had issued the MAI, it had already decided in broad terms the subject matter of the proposed investigation and had recorded this, succinctly, in the ERD (see for example the section of the ERD issued to Mr Cumming's entitled *'Summary of potential breaches of legislation or FSA Principles or Rules'*, as quoted at paragraph 97 above).

362. Unless the Decision-Maker considers there to be compelling reasons not to do so (such reasons being properly recorded), the Regulators should include within the MAI (or alternatively in a separate document which is also sent to the subject of an investigation) a succinct summary of the potential breaches and a succinct explanation of the matters that are said to give rise to those breaches. The level of detail envisaged is similar to the level of detail contained in the '*Summary of potential breaches of legislation or FSA Principles or Rules*'.

363. This recommendation is consistent with the Government's sixteenth recommendation in HM Treasury's '*Review of enforcement decision-making at the financial services regulators: final report*': *"The government recommends that regulators provide more information within [MAI] or in accompanying documents, as to the basis for a subject's referral to enforcement. In particular, explanations for referral should link expressly to the published referral criteria, to enhance transparency."*

Recommendation 4: Accuracy of ExCo minutes

364. The Regulators should put in place a system whereby minutes of ExCo meetings are properly reviewed and approved. The minutes of a meeting must accurately record the discussions and decisions that take place during the meeting as, otherwise, they are of limited use and potentially misleading (paragraphs 126, 266, 339 and 340 above). It is, therefore, important that a procedure is put in place whereby ExCo minutes are properly reviewed and approved.

Annexes

Assessment of the FSA's Enforcement Investigations

Annexe 1:
List of Interviewees

List of Interviewees

1. Peter Cummings (2 May 2014)
2. Tracey McDermott (19 May 2014)
3. Ms Williams*, FSA manager, HBOS Supervision Team (20 May 2014)
4. Mr Taylor*, Enforcement Relationship Manager (20 May 2014)
5. Ms Evans*, FSA chief Counsel (21 May 2014)
6. Clive Adamson (22 May 2014)
7. Sir Hector Sants (24 June 2014)
8. Mr Jones*, manager Enforcement (25 June 2014)
9. Mr Walker*, Head of Department, Retail 1 Enforcement (27 June 2014)
10. Mr Smith*, (30 June 2014)
11. Margaret Cole (8 July 2014)
12. Ms Thomas*, FSA manager, HBOS Supervision Team (10 July 2014)
13. Mr Johnson*, Head of Department, Supervision (10 July 2014)
14. Jon Pain (28 July 2014)
15. Mr Hall*, Head of Department MRGD Supervision (27 August 2014)

* These are fictitious names (see footnote 6).

Annexe 2: Protocol and Terms of Reference for the HBOS Review

Protocol and Terms of Reference for the HBOS Review

PROTOCOL

For the conduct of the review of the enforcement response in light of the failure of HBOS

A. Introduction

1. Counsel has been appointed by the FCA and the PRA ("**the Regulators**") to carry out a review of the FSA's enforcement decisions in relation to HBOS.

2. The Terms of Reference set out the scope of the review.

3. This Protocol sets out the procedures under which the review is to be carried out. It has been agreed with the Regulators and shared with the Chairman of the Treasury Select Committee ("**the TSC**").

B. Administrative Matters

4. Counsel has been given contacts at the FCA.

5. A dedicated email in-box for communications relating to Counsel's review has been set up. Counsel should send his communications relating to the review to this in-box.

6. The FCA will arrange for Counsel and his team to be given reasonable access to the FCA's premises in Canary Wharf.

C. Documents, other information and interviews

Documents: requests and production

7. Counsel will send all requests for the production of documents by email to the email address referred to in clause 5 above. Such requests will set out the document or class of documents required for production.

8. Provided that the documents requested are within the Regulators' power, custody or possession, such documents will be provided to Counsel (either on disc or in hard copy) as soon as possible. No such documents will be withheld from Counsel.

General information requests and general explanations

9. In the event that Counsel requires other information and/or explanations as to the FSA's/FCA's enforcement activities, any such request will be sent by email to the email address referred to in clause 5 above.

10. The Regulators will respond as soon as possible to any such request, and no such information will be withheld from Counsel. The response will identify the person(s) who have provided the requested information and/or explanations.

Interviews

11. In the event that Counsel wishes to carry out interviews with individuals, he will notify the Regulators (by email to the email address referred to in clause 5 above) of the individuals whom he wishes to interview.

12. The Regulators will endeavour to secure the attendance at interview of all such witnesses (whether those individuals are current or former employees of the Regulators). Interviews will be arranged at a mutually convenient time. Counsel will provide to the FCA, to allow the FCA to pass on to interviewees no less than 5 working days in advance, (i) a broad outline of the topics Counsel wishes to raise with the interviewee and (ii) a list of the principal documents which Counsel wishes to put to the interviewee.

13. The FCA will provide the facilities necessary for the carrying out of those interviews. In particular, it will provide a suitable room at its premises at North Colonnade or 1 Canada Square; and it will ensure that all interviews are recorded on dual recording equipment. It will also ensure that a transcript is prepared shortly after the interview, and provided on disc and in hard copy to Counsel, to the interviewee, to the PRA Review Team and to the FCA's GCD.

14. Interviewees may be accompanied by a legal adviser, Human Resources or other suitable representative.

15. The information obtained by reason of the interviews may be relied upon by Counsel in preparing his report.

D. Privilege & Confidentiality

Privilege

16. Given the nature of enforcement decision-making, it will be necessary for Counsel to receive information which is subject to the FCA's legal privilege. The FCA will not withhold documents from Counsel on grounds of privilege, but the FCA is not thereby waiving privilege in the documents so provided to Counsel.

17. Counsel may refer to privileged documents in his report, but the Regulators will decide whether to redact parts of the report before it is subject to Maxwellisation or its publication on the basis that it refers to such privileged documents. If the Regulators decide to redact parts of the report on that basis, they will include in the Report of the overall review an explanation of the reasons for the redactions.

Confidentiality

18. Counsel will be provided by the Regulators with "confidential information" within the meaning of section 348 FSMA. If so, when providing such information to Counsel, the Regulators will identify the fact that it is confidential. Counsel may refer to such confidential information in his report. It will be for the Regulators to seek to obtain the consent of the person from whom the information was received or, if different, the person to whom it relates. If such consent is not obtained, Counsel may nevertheless refer to such confidential information in the report and the Regulators will then decide whether to redact parts of the report before its publication on the basis that it refers to such information. If the Regulators decide to redact parts of the report on that basis, they will include in the Report of the overall review an explanation as to the reasons for the redactions.

E. Maxwellisation

19. Insofar as Counsel intends in his report to make criticism of individuals or organisations, (1) Counsel will identify those individuals or organisations, who will be given a reasonable opportunity to make representations in relation to such proposed criticisms and, having received any responses, (2) Counsel will consider those responses with an open mind prior to producing his report.

20. The Regulators, through the contacts listed in clause 4 above, (1) will assist Counsel (if so requested) in deciding which individuals or organisations should be given an opportunity to make such representations, and (2) will provide Counsel with such administrative assistance as is reasonably required by Counsel for the purpose of conducting this Maxwellisation process.

F. Publication

21. The Regulators will be responsible for publishing Counsel's report, which will be published as part of the Report of the overall review. The final decision on publication will be made by the Regulators' Boards (or a duly authorised committee of the relevant Board).

G. Governance and reporting

22. The Boards of the Regulators have appointed a joint Steering Group to oversee the production of the HBOS Report, including the report that Counsel is producing. If requested to do so, Counsel will keep the Steering Group informed as to the progress of the report. Counsel will on request provide pre-and post-Maxwellisation versions of his report to the Steering Group to assist it in addressing issues relating to matters such as legal privilege, information which is confidential under section 348 FSMA and those affecting the management of the regulators. The Steering Group will determine what, if any, further disclosure may be necessary, having regard to any conflicts of interests. Counsel will inform the TSC of any issues arising from contact with the Steering Group concerning the production of the report at all stages. Counsel will also inform the TSC if he considers that the pre-Maxwellisation version of the report is unlikely to be ready within the agreed timeframe.

23. For the purpose of preparing his report, Counsel may meet with the Independent Reviewers who have been appointed by the Regulators and the TSC to advise on the overall review.

Detailed Terms of Reference for the HBOS Review

A report by the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA) into the failure of HBOS plc (HBOS)

1. The Board of the Financial Services Authority (FSA) commissioned a report into the failure of HBOS. It was not appropriate to launch a wider review until the conclusion of certain enforcement proceedings. Those proceedings concluded in September 2012 and the FSA commenced its review of HBOS at that time. As preparation of the Report has spanned the change in the structure of financial services regulation in the UK on 1 April 2013, the Report will be jointly published by the FCA and PRA.

2. The **purpose** of the review is to:

   (a) explain and describe: why HBOS failed; the supervision of HBOS;

   (b) assess the FSA's enforcement investigations following the failure of HBOS, as set out in 4(f) below; and

   (c) inform a wider internal and public understanding of the causes of failure during the crisis (to the extent not already covered by *The RBS report*[1]).

3. (a) The Review **Period** will focus mainly on 1 January 2005 to 1 October 2008, the date when HBOS was in receipt of Emergency Liquidity Assistance (ELA) from the Bank of England. b) For the enforcement section of the Review, the Review Period will be from 1 October 2008 to 12 September 2012, the date of the Final Notice given to Peter Cummings.

4. The Review **scope** will:

   (a) summarise why HBOS failed;

   (b) assess HBOS' capital, asset quality and liquidity positions, as well as systemic vulnerabilities during the period;

   (c) assess management, governance and culture at HBOS at the time;

   (d) assess the key elements of the FSA's supervision of HBOS in the period;

   (e) address the issues set out in paragraphs 141(a) to (g) and (i) in the Parliamentary Commission on Banking Standards' Report into the failure of HBOS[2], paragraph 141(h) being addressed by paragraph 4(f) of these Terms;

   (f) assess the reasonableness of the scope of the FSA's enforcement investigations in relation to the failure of HBOS during the Review Period (i.e. October 2008 to September 2012), including offering an opinion, based on Andrew Green QC's review, as to whether the regulators should consider afresh whether any other former members of HBOS's senior management should be subject to an investigation with a view to prohibition proceedings[3]; and

(1) Financial Services Authority Board Report entitled *The failure of the Royal Bank of Scotland* December 2011
(2) Parliamentary Commission on Banking Standards report entitled *''An accident waiting to happen': The failure of HBOS'* March 2013
(3) Thus addressing paragraph 141(h) of the PCBS report

(g) make any recommendations arising out of the above that have not already been covered in the previous reports, specifically Northern Rock[4], *The Turner Review*[5] and RBS.

5. The report will also include a high level analysis of the balance sheets of the Bank of Scotland and Halifax in 1998 – 2001, and of the merged HBOS balance sheet in 2001 – 2005, focusing on key prudential indicators such as capital and leverage ratios. It will not examine the particular causes and consequences of the Lloyds/HBOS merger itself, but will examine the quality of the HBOS loan book in 2008, considering both what was known before October 2008 and what subsequently came to light.

6. It is anticipated that significant elements of relevant material have already been covered in detail in the RBS report. To the extent this is the case, the report will summarise and refer to this material within this report, which will, nevertheless, be a substantive report and will remain a standalone document.

7. The **approach** and inputs to the review include:

   (a) analysis conducted by the FSA Prudential Business Unit/PRA's Supervisory Oversight Function. This function is responsible for reviewing the effectiveness of prudential supervision;

   (b) an assessment of management, governance and culture at HBOS supported by an external third party, Grant Thornton; and

   (c) placing reliance where appropriate on analysis already published within the RBS report, for example setting out the FSA's approach to supervision in the period.

8. For the enforcement section, the assessment of the reasonableness of the FSA's enforcement investigations will be carried out by a team of independent Counsel led by Andrew Green QC, who will be the author of this part of the report.

9. **Oversight** is provided by a dedicated steering committee comprising Board members of the PRA and FCA respectively. Separately, external independent reviewers have been agreed with the Treasury Committee[6] to review the first four sections of the Report (but not the enforcement section, which is being prepared separately). This approach will provide independent scrutiny and challenge to facilitate the production of a robust report.

10. **Clearance and publication**. The aim is to publish the final report by the end of this year. This timescale incorporates the time needed by the external independent reviewers to complete their review, for Counsel to conduct their enforcement review and the Maxwellisation process, whereby the firm and any individuals subject to potential criticism are given an opportunity to make representations in response to the review's proposed findings. As the report will draw heavily on confidential information previously provided by HBOS and other relevant parties, their consent will also be legally required before publication of this information.

11. The Financial Services Act 2012 (FSA 2012) established the **future arrangements** for investigating regulatory failures. Under this approach, Her Majesty's Treasury will decide whether a firm failure is of a scale and nature which justifies the production of a public report, if the regulator has not already independently decided to produce one. The HBOS review is not being undertaken under FSA 2012. Ahead of that system being in place, the FSA's judgement was that the public's legitimate interest in understanding the key drivers of the 2008 financial

(4) Financial Services Authority report entitled '*The supervision of Northern Rock: a lessons learned review*' March 2008
(5) Financial Services Authority report entitled '*The Turner Review: A regulatory response to the global banking crisis*' March 2009
(6) http://www.parliament.uk/documents/commons-committees/treasury/Terms%20of%20Reference%20HBOS%20review.pdf

crisis, would be served effectively by the publication of reports on RBS and HBOS, together with the earlier report which the FSA produced on Northern Rock and *The Turner Review's* report on the overall regulatory system.

Annexe 3:
Draft ERD dated 30 January 2009

ENFORCEMENT REFERRAL DOCUMENT ("ERD")

This ERD is to be completed jointly by the referring department, the lead supervisor (if different) and the Enforcement Relationship Managers ("ERM") when considering whether Enforcement tools should be used to address an issue of concern. Before attempting to complete it please discuss it with your ERM.

This ERD should be completed in accordance with the guidelines set out in the ERD Guidance Note. All specific references in the ERD to a "Note" are to those guidelines.

Please ensure that all documents you refer to in completing this ERD are included in the Annex.

1. BASIC INFORMATION

1.1 Name and reference number of Firm/Individual [where authorised/approved] (Note 1.1)

Peter J Cummings (Individual Reference Number PGC01301)

1.2 Contact in referring department [and lead supervisor, where different] (Note 1.2)

Ms Williams (Manager, MRGD2), succeeded by Ms Thomas (Manager, MRGD3)
Associate, Supervision (former HBOS lead supervisor)

Associate, Supervision (Supervisor HBOS Corporate)

1.3 Summary of potential breaches of legislation or FSA Principles or Rules (Note 1.3)

There are circumstances to suggest that Peter Cummings may have breached Statements of Principle 5, 6 and 7 of APER as a result of failings in his responsibilities as an executive Director of HBOS Plc and CEO of its Corporate Division.

In summary, the FSA identified in 2007 that the regulatory risk profile of HBOS' Corporate Division was high and that its risk management systems fell short of the standards reasonably expected by the FSA. Under Mr Cummings' leadership, HBOS' Corporate loan book and its risk profile grew considerably throughout 2007 and 2008 – a time when the economic environment was deteriorating other banks , when it would have been prudent, given the systems and controls issues identified across the Division, for it to have been exposed to less risk [as was happening at HBOS' competitors]. Is this right?
Mr Cummings was instrumental in the running of HBOS' Corporate division and personally responsible for its failings.

Commented [A1]: Is this right?

Commented [A2]: Can you please comment in whether this is an appropriate and accurate summary of our concerns?

2. ISSUES & FACTS

2.1 FSA Objectives and Priorities (Notes 2.1)

2.1.1 FSA Objectives (Note 2.1.1)

Mr Cummings' alleged misconduct poses a risk to the FSA's objective of maintaining confidence in the financial system for which integrity, competence and judgement of individuals holding significant influence functions is of central importance.

2.1.2 Strategic priorities (Note 2.1.2)

One of the strategic priorities of the FSA under the Supervisory Enhancement Programme is to ensure that Significant Influence Function (SIF) holders are fit and proper. The integrity, competence and judgement of individuals are important parts of this.

2.2 Detailed reasons for referral, by reference to Referral Criteria (Note 2.2)

Background

Until his resignation, following the takeover of HBOS plc by Lloyds Banking Group completed on 19 January 2009, Mr Cummings was an executive director of HBOS plc and CEO of Corporate, the group's commercial lending business. He was appointed CEO of the HBOS Corporate Division in January 2006 and, from 1995 until his appointment to the main board, Mr Cummings was a Director of Corporate Banking.

Please include a brief explanation of the reporting lines to and from Cummings

By end of June 2008, HBOS loans and advances to Corporate customers amounted to £117bn representing 26 % of the group's loan book.

Evolution of loans and advances:

£bn	6-2008	12-2007	6-2007	12-2006	6-2006	12-2005
Retail	256	253	242	238	229	219
Corporate	117	109	96	89	86	79

The Corporate Division's balance sheet grew by 48% over the two and half years from the time Mr Cummings took up his appointment. By way of comparison, HBOS Retail business grew by 17% over the same period.

Please include some comparative data here – it would be helpful to understand what competitors were doing.

There were a number of factors driving the business that will have contributed to the growth in the Corporate loan book namely:

- Closure of the loan syndication market during the second half of 2007 leaving banks, including HBOS, with unsold underwriting positions
- Draw downs on committed facilities ("involuntary lending")
- The lag between offering loans to customers and these loans being drawn down - some offers would have been legally binding, others may have been regarded as morally binding

To a lesser degree, some growth in the book may have arisen from exchange rate movements (some of Corporate's balances will be $ and € denominated) and an element of reallocation of assets between the Corporate and Retail divisions

Commented [A3]: This would appear to be mitigation. Do we have a view on what extent it was reasonable for these factors to contribute to the loan book growth.

Notwithstanding these factors, the growth in Corporate loans was considerable and the book continued to grow throughout 2007 and 2008 as did the risk profile of the portfolio.

Please provide here a some commentary on the supervisory history of the Corporate Division i.e. the 15 Oct 07 Arrow Discovery Plan (page 5) refers to the FSA's concern about the risk appetite of the Group and its significant exposure to commercial property and its control of risks

The growth of the Division combined with the FSA's concerns about the funding problems faced by the HBOS group as a whole, the high risk nature of the book (in particular property lending, equity participations, leveraged loans) and a number of control failures over 2007/8 against a backdrop of a weakening economic environment lead Supervision to commission PRD (Retail Policy & Conduct Risk) to conduct a review of the Division during the period April – July 2008. This review identified a number of system and control weaknesses across the Corporate division. These weaknesses were presented to Mr Cummings on 1 August 2008 and were formalised in a letter and risk mitigation programme dated 17 October 2008.

Commented [A4]: When were these articulated to Cummings?

Commented [A5]: What were these and did we make Cummings personally aware?

Explain here how Cummings responded, what MRGD think of his response and why we consider he failed to address the concerns

The issues identified in HBOS's Corporate division have led Supervision to conclude that the assessment, reporting and control of risk, did not match the scale and type of business being undertaken. In his role as an approved person and CEO of the Corporate Division, Mr Cummings had overall responsibility for ensuring systems and controls of this division were adequate for the volume and risk profile being written.

By the end of November 2008, the risk posed by the Corporate book had started to crystallise and the division disclosed an £3.3bn impairment charge for the eleven month period. Further impairments are expected.

Reasons for referral, having regard to referral criteria:

Has there been actual or potential consumer loss/detriment?

Yes. There was potential loss to consumers arising from investor/depositor loss in confidence.

HBOS's considerable exposure to commercial property lending was one of the factors that contributed to investors concerns, thereby triggering a share price rout that had a knock on impact on liquidity, both wholesale and retail. Customer accounts provided £258bn of funding to the group as of December 2008 .Without the announcement of the takeover by Lloyds and extensive Government/Bank of England liquidity support, the firm was at risk of collapse with potential detriment to customers.

Is there evidence of financial crime or risk of financial crime?

Yes. There was a potential risk of fraud and financial crime arising from poor systems and controls.

- The failure to reconcile payments in a timely manner could result in delays to recognising unusual or fraudulent payments;
- The failure to register charges over properties against which HBOS had advanced funds leaves the firm more exposed to fraud;
- Possible valuation fraud is now being investigated by the firm in relation to its loan [redacted][1]

Are there actions or potential breaches that could undermine public confidence in the orderliness of financial markets?

Potential misconduct by senior management of high impact firms, such as that of Mr Cummings, could serve to undermine public confidence as the public should be able to rely on the competence and judgement of SIF holders.

Are there issues that indicate a widespread problem or weaknesses at the firm?

Yes. There are widespread systems and controls weaknesses within the Corporate division which are detailed in the RMP programme issued to the firm on 17 October 2008. The extensive nature of these weaknesses would indicate that the Group Risk and Group Audit functions were not providing effective second and third lines of defence.

Commented [A6]: Please explain whether we consider these to be failings at Group level of HBOS or if this is something which Cummings had responsibility for.

Is there evidence that the firm/issuer/individual has profited from the action or potential breaches?

[1] *This name has been redacted to preserve the anonymity of the identified customer.*

Yes. Mr Cummings benefited from significant bonus payments from 2006 to 2008 although there is at present no evidence to suggest this was a direct result of his potential misconduct i.e. his benefit was indirect. He was the highest paid HBOS Board Director in 2007 with total remuneration of £2,448k of which £1,796k was attributed to 'annual cash incentives'. This represented approximately half of the total bonus pool for the Board as a whole. His total remuneration in 2006 was £1,491k.

Commented [A7]: Is this right?

Mr Cummings was also eligible for a separate additional short term incentive plan not applicable to the other Executive Directors in which the amount paid out in cash would be matched by an equivalent deferred cash amount which will be sued to buy shares after the end of 2010. In 2007 the additional deferred incentive payable to Mr Cummings amounted to £1,320k.

Has the firm/issuer/individual failed to bring the actions or potential breaches to the attention of the FSA?

Yes. The firm has brought to the FSA's attention some specific control failures arising in the Corporate Division (see below) although did not raise any concerns about Mr Cummings' competence and judgement. Mr Cummings did inform Supervision on more than one occasion that he was in the process of strengthening the team in areas such as risk and operations which may be perceived as an acknowledgement that his executive was not previously of the calibre the business required.

Commented [A8]: Clarification of the history of the control failures would be helpful.

Control failures brought to the FSA's attention: Internal credit control failings ([Branch B]) and a backlog in Reconciliations (Loan Management system).

Commented [A9]: Are these the control failures referred to above on page 2?. May need to expand to demonstrate Cummings' awareness / involvement at the time.

Is the issue to be referred relevant to an FSA strategic priority?

As part of the Supervisory Enhancement Programme the FSA concentrates on SIFs being fit and proper. Mr Cumming's alleged misconduct might demonstrate he lacks competence and judgement and therefore the fitness and propriety to be an approved person.

What was the reaction of the firm/issuer/individual to the breach?

Mr Cummings is not aware that FSA is considering an enforcement referral. He is aware that the FSA conducted a review of the business for which he was responsible over the course of 2008 that resulted in an extensive programme of risk mitigation actions that HBOS is now endeavouring to complete.

Overall, is the use of the enforcement tool likely to further the FSA's aims and Objectives?

Yes, insofar as it would serve as notice to firms and individuals that the FSA is taking the matter of the competence and judgement of senior management seriously.

2.3 Potential breaches (Note 2.3)

The following APER Statements of Principle are relevant to this matter:

- Statement of Principle 5: An approved person carrying out a significant influence function must take reasonable steps to ensure that the business of the firm for which he is is organised so that it can be controlled effectively.

- Statement of Principle 6: An approved person performing a significant influence function must exercise due skill, care and diligence in managing the business of the firm for which he is responsible in his controlled functions.

- Statement of Principle 7: An approved person performing a significant influence function must take reasonable steps to ensure the business of the firm for which he is responsible in his controlled functions complies with the relevant requirements and standards of the regulatory system.

With reference to the RMP dated 17 October 2008, the SIF Project Team (Geoff Tierney) carried out an analysis of the issues arising in the RMP and applied the relevant provisions of APER. That analysis is set out below:

	Issue identified by the FSA	Relevant APER SIF non-compliant behaviour
1	The nature of the Division's business means there is a significant exposure to credit risk. Where policies and procedures around credit risk are not sufficiently comprehensive or robust there is the risk that the firm is unable to properly understand and control exposures.	APER 4.6.4 Permitting transactions without a sufficient understanding of the risks involved Permitting expansion of the business without reasonably assessing the potential risks of that expansion; Inadequately monitoring highly profitable transactions or business practices or unusual transactions or business practices; Accepting implausible or unsatisfactory explanations from subordinates without testing the veracity of those explanations; Failing to obtain independent, expert opinion where appropriate.
2	Data used in the credit process, such as property valuations and ratings should be up to date. Where gaps or lags occur appropriate conservatism should be applied in the use of the data	
3	HBOS Corporate to enhance its processes for on-going sector risk management – and ensure sector risks within Corporate are effectively managed	
4	HBOS Corporate to enhance its early warning indicator framework	It is important for an approved person performing a significant influence function to understand the risks of expanding the business into new areas and, before approving the expansion, he should investigate and satisfy himself, on reasonable grounds, about the risks, if any, to the business. (4.6.12)
5	High levels of concentration in the book could leave the firm over exposed to market fluctuations. It is unclear the extent to which this concentration risk has been assessed for example, across the asset classes	Permitting *transactions* without a sufficient understanding of the risks involved (4.6.4)
6	Whilst such concentrations may be a consequence of the chosen RE strategy it is not evident that such concentration limits have been robustly challenged both within the Division and by Group	Strategy and plans will often dictate the risk which the business is prepared to take on and high level controls will dictate how the business is to be run. If the strategy of the business is to enter high-risk areas, then the degree of control and strength of monitoring reasonably required within the business will be high. In organising the business for which he is responsible, the approved person performing a significant influence function should bear this in mind.
7	Given market illiquidity and volatility there is a need to adopt an appropriate and robust approach to valuing equity held on the balance sheet.	Where unusually profitable business is undertaken, or where the profits are particularly volatile or the business involves funding requirements on the firm beyond those reasonably anticipated, he should require explanations from those who report to him. Where those explanations are implausible or unsatisfactory, he should take steps to test the veracity of those explanations

8	Inadequacies in preventative controls gave staff unimpeded access to change credit limits. Detective controls were in some cases not applied and in others ineffective. Additionally the Joint Ventures asset class has experienced a rise in impairments that have highlighted potential control failings.	Failing to take reasonable steps to ensure that procedures and systems of control are reviewed and, if appropriate, improved, following the identification of significant breaches (whether suspected or actual) of the relevant requirements and standards of the regulatory system relating to its regulated activities, falls within APER 4.7.2 E (see APER 4.7.13 G).
9	A resource shortage and pattern of incomplete reporting by counterparties led to backlogs (6,234 items in July 2007 peaking at a backlog of over 14,000 in May 2008). Development of a strategic solution was only presented to the FSA in July 2008	Failing to take personal action where progress is unreasonably slow, or where implausible or unsatisfactory explanations are provided (4.6.9)
10	There have been several instances where HBOS's charge over property has not been registered by the acting solicitors and the loan therefore is not in compliance. Lack of due diligence in this area may result in financial loss to the firm.	Failing to take reasonable steps to implement (either personally or through a compliance department or other departments) adequate and appropriate systems of control to comply with the relevant requirements and standards of the regulatory system in respect of its regulated activities(4.7.3)
11	There is a multiplicity of Committees to manage specific aspects of risk at the expense of integration across the piece.	Failing to take reasonable steps to apportion responsibilities clearly amongst those to whom responsibilities have been delegated falls within APER 4.5.2 E (see APER 4.5.11 G).
12	For instance, where information is privileged to equity investors there may be a tension with duties towards debt syndicate members especially where HBOS may also be acting as Agent. Whilst the conflicts policy notes this possibility and recognises potential triggers (e.g. impairment), it is unclear how these risks are being managed	Permitting expansion of the business without reasonably assessing the potential risks of that expansion (4.6.4)
13	The firm has demonstrated that it has someway to go to meet ongoing requirements of the Basel models. Reviews of PIM in January and June 2008 showed the model to be non-compliant while the GCM review has been subjected to several delays generated in part by the absence of documentation and adequate performance of the model to support the review.	Failing to take reasonable steps to monitor (either personally or through a compliance department or other departments) compliance with the relevant requirements and standards of the regulatory system in respect of its regulated activities falls within APER 4.7.2 E (see APER 4.7.12 G). Unreasonably failing to implement recommendations for improvements to systems and procedures in a timely manner.(4.7.8)

The issues set out above demonstrate that Mr Cummings, as CEO of HBOS' Corporate division, may have failed in his duties as a significant influence function holder under the FSA's approved persons regime.

2.4 Other relevant factors (Note 2.4)

Is there anything else to add which might be relevant to the decision whether to refer.

Please explain to what extend the concerns extend beyond Cummings to Group and why no other individuals should be referred.

3. SIGN OFF

3.1 Referring department (Note 3.1)

_____
Ms Williams, Referring Manager, MRGD2, Major Retail Groups Division, January 2009

3.2 Lead Supervisor (where different from 3.1 above) (Note 3.2)

N/A_____
Responsible Supervision Manager, Department, Division and Date

3.3 Enforcement (Note 3.3)

_____ _____

Enforcement Relationship Manager, January 2009

Enforcement Head of Department, January 2009

ANNEX – Documents referred to in this ERD

This section is for the referring department in Supervision to complete.

Guidelines on the referencing of annexed documents can be found in the ERD Guidance Note (referenced Annex 1).

Tab	Doc date	Document description

Please list here those key documents that are particularly relevant to the decision to refer, such as the note of the 1 August meeting, 17 October RMP, PRD analysis etc

Annexe 4: The signed ERD dated 26 February 2009

ENFORCEMENT REFERRAL DOCUMENT ("ERD")

This ERD is to be completed jointly by the referring department, the lead supervisor (if different) and the Enforcement Relationship Managers ("ERM") when considering whether Enforcement tools should be used to address an issue of concern. Before attempting to complete it please discuss it with your ERM.

This ERD should be completed in accordance with the guidelines set out in the ERD Guidance Note. All specific references in the ERD to a "Note" are to those guidelines.

Please ensure that all documents you refer to in completing this ERD are included in the Annex.

1. BASIC INFORMATION

1.1 Name and reference number of Firm/Individual [where authorised/approved] (Note 1.1)

Peter J Cummings (Individual Reference Number PGC01301)

1.2 Contact in referring department [and lead supervisor, where different] (Note 1.2)

Ms Williams (Manager, MRGD2), succeeded by Ms Thomas (Manager, MRGD3)
Associate, Supervision (former HBOS lead supervisor)

Associate, Supervision (Supervisor HBOS Corporate)

1.3 Summary of potential breaches of legislation or FSA Principles or Rules (Note 1.3)

There are circumstances to suggest that Peter Cummings may have breached Statements of Principle 5, 6 and 7 of APER as a result of failings in his responsibilities as an executive Director of HBOS Plc and CEO of its Corporate Division.

In summary, the FSA identified in 2007 that the regulatory risk profile of HBOS' Corporate Division was high and that its risk management systems fell short of the standards reasonably expected by the FSA. Under Mr Cummings' leadership, HBOS' Corporate loan book and its risk profile grew considerably throughout 2006 and 2007 when it would have been prudent, given the systems and controls issues identified across the Division, for it to have been exposed to less risk. Mr Cummings was instrumental in the running of HBOS' Corporate division, proposing the strategy and the risk appetite that was endorsed by the Board. In his capacity as CEO he also had responsibility for ensuring the division had systems and controls commensurate to the risks they were taking. Mr Cummings regularly attended Risk Committees and all deals of £250m and above (this limit was lowered during 2008) would have required his personal sign-off alongside that of another Executive Director, Colin Matthew. He therefore appears to be personally responsible for its failings.

2. ISSUES & FACTS

2.1 FSA Objectives and Priorities (Notes 2.1)

2.1.1 FSA Objectives (Note 2.1.1)

Mr Cummings' alleged misconduct poses a risk to the FSA's objective of maintaining confidence in the financial system for which integrity, competence and judgement of individuals holding significant influence functions is of central importance.

2.1.2 Strategic priorities (Note 2.1.2)

One of the strategic priorities of the FSA under the Supervisory Enhancement Programme is to ensure that Significant Influence Function (SIF) holders are fit and proper. The integrity, competence and judgement of individuals are important parts of this.

2.2 Detailed reasons for referral, by reference to Referral Criteria (Note 2.2)

Background

Until his resignation, following the takeover of HBOS plc by Lloyds Banking Group completed on 19 January 2009, Mr Cummings was an executive director of HBOS plc and CEO of Corporate, the Group's commercial lending business. He was appointed CEO of the HBOS Corporate Division in January 2006 and, from 1995 until his appointment to the main board, Mr Cummings was a Director of Corporate Banking.

By end of June 2008, HBOS loans and advances to Corporate customers amounted to £117bn representing 26 % of the group's loan book.

Evolution of loans and advances:

£bn	6-2008	12-2007	6-2007	12-2006	6-2006	12-2005
Retail	256	253	242	238	229	219
Corporate	117	109	96	89	86	79

The Corporate Division's balance sheet grew by 48% over the two and half years from the time Mr Cummings took up his appointment. By way of comparison, HBOS Retail business grew by 17% over the same period.

There were a number of factors driving the business that will have contributed to the growth in the Corporate loan book from late 2007 onwards:

- Closure of the loan syndication market during the second half of 2007 leaving banks, including HBOS, with unsold underwriting positions
- Draw downs on committed facilities ("involuntary lending")
- The lag between offering loans to customers and these loans being drawn down - some offers would have been legally binding, others may have been regarded as morally binding
- Some growth in the book may have arisen from exchange rate movements (some of Corporate's balances will be $ and € denominated) and an element of reallocation of assets between the Corporate and Retail divisions to a lesser degree,

Notwithstanding these factors, the growth in Corporate loans from end 2005 was considerable and the book continued to grow throughout 2007 and 2008 as did the risk profile of the portfolio. Two aspects of the Division's strategy stand out: (1) its overt unique selling point of taking equity participations in many of its deals (amounting to £9.5bn as of Dec 2008) which not only increased its risk profile but also added complexity to its operations and (2) the heavy and deliberate concentration of lending to the UK property and construction sector. Notwithstanding this risk appetite, the Division's cost income ratio remained unusually low at 23.2% (2007), a possible indicator of low investment in controls and systems relative to the risk it was taking on.

There were a series of control failures that the Division brought to the FSA's attention over the past 2 years:

- In the first half of 2007, the division encountered a mainframe failure caused by the application of a patch for minor up-grade. Crisis management was slow to realise the gravity of the issue. Quantifiable losses were minor but they suffered reputational damage and loss of staff time.
- [redacted] This pointed to lack of preventative and detective controls. Group Internal Audit had picked up this control weakness in an audit some years previously but remedial action had not been carried out by the division in a timely fashion. Losses from this control failure amounted to £200m.

- In July 2007, the division advised the FSA that it had a backlog of over 6,000 reconciliations in its Loan Management System. During ARROW meetings in November 2007, the firm set and the FSA agreed the deadline for remediation of April 2008. However, by May 2008 the backlog had grown to 12,000. Supervision took this up with Peter Cummings personally later that month and he committed to getting them back on track. Although direct losses are difficult to quantify, this continuing backlog put the firm at risk of fraud and credit losses.
- The firm informed Supervision in March 2008 that it had overstated its Corporate RWAs by £7bn. This followed a similar problem back in 2007 after which it had undertaken a data cleansing exercise. One of its internal documents dated 14 March 2008 comments "we cannot operate and plan accurately with such levels of data quality errors". In a meeting between Supervision and Mr Cummings in July 2007, he described the performance of the Division as "spectacular". He commented at that meeting that he considered the controls to be "adequate" but recognised the need for better and more timely provision of data, particularly to meet Basel requirements.
- Supervision met with the Chair of the Audit Committee, Tony Hobson on 30 July 2008. Mr Hobson commented on his concerns about the Corporate book including control issues. He went on to say that [redacted][1]. In a meeting Supervision held with Ron Garrick, the Deputy Chairman, a couple of days later, Mr Garrick told us that he [redacted][2] He went on to say that Mr Cummings appointment of Philip Grant as Chief Operating Officer in April/May 2008 had strengthened the Division's capabilities and "provided clearer line of sight to Group Risk and the Board". This suggested to Supervision that there was some acknowledgment that the governance and oversight of the Corporate division needed to be strengthened.

The growth of the Division combined with the FSA's concerns about the funding problems faced by the HBOS Group as a whole[3], the high risk nature of the book (in particular property lending, equity participations, leveraged loans) together with the control failures detailed above, against a backdrop of a weakening economic environment led Supervision to commission PRD (Retail Policy & Conduct Risk) to conduct a review of the Division during the period April – July 2008. This review identified a number of system and control weaknesses across the Corporate division. These weaknesses were presented to Mr Cummings on 1 August 2008 and were formalised in a letter and risk mitigation programme dated 17 October 2008.

[redacted][4]

The issues identified in HBOS's Corporate division have led Supervision to conclude that the assessment, reporting and control of risk, did not match the scale and type of business being undertaken. In his role as an approved person and CEO of the Corporate Division, Mr Cummings had overall responsibility for ensuring systems and controls of this division were adequate for the volume and risk profile being written.

By the end of November 2008, the risk posed by the Corporate book had started to crystallise and the division disclosed an £3.3bn impairment charge for the eleven month period. Further impairments are expected. On 13 February, Lloyds banking Group issued an emergency trading statement disclosing that the actual impairment for year end 2008 was £6.7bn on the corporate book.

Reasons for referral, having regard to referral criteria:

---

[1] *This text has been redacted because it contains information for which consent to disclosure was required from Mr Cummings; that consent was not received.*

[2] *This text has been redacted because it contains information for which consent to disclosure was required from Mr Cummings; that consent was not received.*

[3] Concerns were initially raised with HBOS when the wholesale markets began to close in July 2007, monitored frequently and raised in the April 2008 ARROW letter.

[4] *This text has been redacted because it contains information for which consent to disclosure was required from Mr Cummings; that consent was not received.*

Has there been actual or potential consumer loss/detriment?

Yes. There was potential loss to consumers arising from investor/depositor loss in confidence.

HBOS's considerable exposure to commercial property lending was one of the factors that contributed to investors concerns, thereby triggering a share price rout that had a knock on impact on liquidity, both wholesale and retail. Customer accounts provided £258bn of funding to the group as of December 2008. Without the announcement of the takeover by Lloyds and extensive Government/Bank of England liquidity support, the firm was at risk of collapse with potential detriment to customers.

Is there evidence of financial crime or risk of financial crime?

Yes. There was a potential risk of fraud and financial crime arising from poor systems and controls.

- The failure to reconcile payments in a timely manner could result in delays to recognising unusual or fraudulent payments;

- The failure to register charges over properties against which HBOS had advanced funds leaves the firm more exposed to fraud;

- Possible valuation fraud is now being investigated by the firm in relation to its loan [redacted] .

Are there actions or potential breaches that could undermine public confidence in the orderliness of financial markets?

Potential misconduct by senior management of high impact firms, such as that of Mr Cummings, could serve to undermine public confidence as the public should be able to rely on the competence and judgement of SIF holders.

Are there issues that indicate a widespread problem or weaknesses at the firm?

Yes. There are widespread systems and controls weaknesses within the Corporate division which are detailed in the RMP programme issued to the firm on 17 October 2008. The extensive nature of these weaknesses would indicate that the Group Risk and Group Audit functions were not providing effective second and third lines of defence.

Is there evidence that the firm/issuer/individual has profited from the action or potential breaches?

Yes, indirectly, in that Mr Cummings benefited from significant bonus payments from 2006 to 2008. He was the highest paid HBOS Board Director in 2007 with total remuneration of £2,448k of which £1,796k was attributed to 'annual cash incentives'. This represented approximately half of the total bonus pool for the Board as a whole. His total remuneration in 2006 was £1,491k.

Mr Cummings was also eligible for a separate additional short term incentive plan not applicable to the other Executive Directors in which the amount paid out in cash would be matched by an equivalent deferred cash amount which will be sued to buy shares after the end of 2010. In 2007 the additional deferred incentive payable to Mr Cummings amounted to £1,320k.

Has the firm/issuer/individual failed to bring the actions or potential breaches to the attention of the FSA?

Yes. The firm has brought to the FSA's attention some specific control failures arising in the Corporate Division (see above) although did not raise any concerns about Mr Cummings' competence and judgement. Mr Cummings did inform Supervision on more than one occasion that he was in the

[5] *This name has been redacted to preserve the anonymity of the identified customer.*

process of strengthening the team in areas such as risk and operations which may be perceived as an acknowledgement that his executive team was not previously of the calibre the business required.

Is the issue to be referred relevant to an FSA strategic priority?

As part of the Supervisory Enhancement Programme the FSA concentrates on SIFs being fit and proper. Mr Cumming's alleged misconduct might demonstrate he lacks competence and judgement and therefore the fitness and propriety to be an approved person.

What was the reaction of the firm/issuer/individual to the breach?

Mr Cummings is not aware that FSA is considering an enforcement referral. He is aware that the FSA conducted a review of the business for which he was responsible over the course of 2008 that resulted in an extensive programme of risk mitigation actions that HBOS is now endeavouring to complete.

Overall, is the use of the enforcement tool likely to further the FSA's aims and Objectives?

Yes, insofar as it would serve as notice to firms and individuals that the FSA is taking the matter of the competence and judgement of senior management seriously.

2.3 Potential breaches (Note 2.3)

The following APER Statements of Principle are relevant to this matter:

- Statement of Principle 5: An approved person carrying out a significant influence function must take reasonable steps to ensure that the business of the firm for which he is is organised so that it can be controlled effectively.

- Statement of Principle 6: An approved person performing a significant influence function must exercise due skill, care and diligence in managing the business of the firm for which he is responsible in his controlled functions.

- Statement of Principle 7: An approved person performing a significant influence function must take reasonable steps to ensure the business of the firm for which he is responsible in his controlled functions complies with the relevant requirements and standards of the regulatory system.

With reference to the RMP dated 17 October 2008, the SIF Project Team (Geoff Tierney) carried out an analysis of the issues arising in the RMP and applied the relevant provisions of APER. That analysis is set out below:

Issue identified by the FSA	Relevant APER SIF non-compliant behaviour
The nature of the Division's business means there is a significant exposure to credit risk. Where policies and procedures around credit risk are not sufficiently comprehensive or robust there is the risk that the firm is unable to properly understand and control exposures.	APER 4.6.4 Permitting transactions without a sufficient understanding of the risks involved Permitting expansion of the business without reasonably assessing the potential risks of that expansion;
Data used in the credit process, such as property valuations and ratings should be up to date. Where gaps or lags occur appropriate conservatism should be applied in the use of the data	Inadequately monitoring highly profitable transactions or business practices or unusual transactions or business practices; Accepting implausible or unsatisfactory explanations from subordinates without testing the veracity of those explanations;
HBOS Corporate to enhance its processes for on-going sector risk management – and ensure	Failing to obtain independent, expert opinion

sector risks within Corporate are effectively managed	where appropriate.
HBOS Corporate to enhance its early warning indicator framework	It is important for an approved person performing a significant influence function to understand the risks of expanding the business into new areas and, before approving the expansion, he should investigate and satisfy himself, on reasonable grounds, about the risks, if any, to the business. (4.6.12)
High levels of concentration in the book could leave the firm over exposed to market fluctuations. It is unclear the extent to which this concentration risk has been assessed for example, across the asset classes	Permitting *transactions* without a sufficient understanding of the risks involved (4.6.4)
Whilst such concentrations may be a consequence of the chosen RE strategy it is not evident that such concentration limits have been robustly challenged both within the Division and by Group	Strategy and plans will often dictate the risk which the business is prepared to take on and high level controls will dictate how the business is to be run. If the strategy of the business is to enter high-risk areas, then the degree of control and strength of monitoring reasonably required within the business will be high. In organising the business for which he is responsible, the approved person performing a significant influence function should bear this in mind.
Given market illiquidity and volatility there is a need to adopt an appropriate and robust approach to valuing equity held on the balance sheet.	Where unusually profitable business is undertaken, or where the profits are particularly volatile or the business involves funding requirements on the firm beyond those reasonably anticipated, he should require explanations from those who report to him. Where those explanations are implausible or unsatisfactory, he should take steps to test the veracity of those explanations
Inadequacies in preventative controls gave staff unimpeded access to change credit limits. Detective controls were in some cases not applied and in others ineffective. Additionally the Joint Ventures asset class has experienced a rise in impairments that have highlighted potential control failings.	Failing to take reasonable steps to ensure that procedures and systems of control are reviewed and, if appropriate, improved, following the identification of significant breaches (whether suspected or actual) of the relevant requirements and standards of the regulatory system relating to its regulated activities, falls within APER 4.7.2 E (see APER 4.7.13 G).
A resource shortage and pattern of incomplete reporting by counterparties led to backlogs (6,234 items in July 2007 peaking at a backlog of over 14,000 in May 2008). Development of a strategic solution was only presented to the FSA in July 2008	Failing to take personal action where progress is unreasonably slow, or where implausible or unsatisfactory explanations are provided (4.6.9)
There have been several instances where HBOS's charge over property has not been registered by the acting solicitors and the loan therefore is not in compliance. Lack of due diligence in this area may result in financial loss to	Failing to take reasonable steps to implement (either personally or through a compliance department or other departments) adequate and appropriate systems of control to comply with the relevant requirements and standards

the firm.	of the regulatory system in respect of its regulated activities(4.7.3)
There is a multiplicity of Committees to manage specific aspects of risk at the expense of integration across the piece.	Failing to take reasonable steps to apportion responsibilities clearly amongst those to whom responsibilities have been delegated falls within APER 4.5.2 E (see APER 4.5.11 G).
For instance, where information is privileged to equity investors there may be a tension with duties towards debt syndicate members especially where HBOS may also be acting as Agent. Whilst the conflicts policy notes this possibility and recognises potential triggers (e.g. impairment), it is unclear how these risks are being managed	Permitting expansion of the business without reasonably assessing the potential risks of that expansion (4.6.4)
The firm has demonstrated that it has someway to go to meet ongoing requirements of the Basel models. Reviews of PIM in January and June 2008 showed the model to be non-compliant while the GCM review has been subjected to several delays generated in part by the absence of documentation and adequate performance of the model to support the review.	Failing to take reasonable steps to monitor (either personally or through a compliance department or other departments) compliance with the relevant requirements and standards of the regulatory system in respect of its regulated activities falls within APER 4.7.2 E (see APER 4.7.12 G). Unreasonably failing to implement recommendations for improvements to systems and procedures in a timely manner.(4.7.8)

The issues set out above demonstrate that Mr Cummings, as CEO of HBOS' Corporate division, may have failed in his duties as a significant influence function holder under the FSA's approved persons regime.

2.4 Other relevant factors (Note 2.4)

Although the allegations made in 2004 by Paul Moore, formerly the Head of Group Regulatory Risk at HBOS, and the events which gave rise to the FSA's press statement dated 11 February 2009, are relevant to the FSA's regulatory perception of the HBOS Group as a whole, they are not material to this decision to refer Mr Cummings for investigation as they predate the period in which his potential misconduct occurred i.e. post 2006.

3. SIGN OFF

3.1 Referring department (Note 3.1)

_____
Ms Williams, Referring Manager, MRGD2, Major Retail Groups Division, 24 February 2009

3.2 Lead Supervisor (where different from 3.1 above) (Note 3.2)

N/A_____
Responsible Supervision Manager, Department, Division and Date

3.3 Enforcement (Note 3.3)

_____ _____

Enforcement Relationship Manager, date **Enforcement Head of Department, date**

ANNEX – Documents referred to in this ERD

This section is for the referring department in Supervision to complete.

Guidelines on the referencing of annexed documents can be found in the ERD Guidance Note (referenced Annex 1).

Tab	Doc date	Document description
1	17.10.2008	FSA risk assessment letter to Peter Cummings
2	17.10.2008	Risk Mitigation Programme for HBOS Corporate Division
3	01.08.2008	Note of meeting with Ron Garrick , Deputy Chair
4	01.08.2008	Note of meeting with Peter Cummings
5	30.07.2008	Note of meeting with Tony Hobson, Chair of Audit Committee
6	22.07.2008	PRD findings arising from HBOS Corporate Visit
7	30.05.2008	Note of teleconference with HBOS to discuss Loan Management System
8	29.04.2008	Preliminary PRD assessment of HBOS Commercial Real Estate portfolio
9	14.03.2008	Internal note from Stewart Livingston “Capital, RWAs and Behavioural Change”
10	05.12.2007	ARROW meeting note with Peter Cummings
11	26.07.2009	HBOS report on [Branch B] Control failure
12`	24.07.2007	C&C meeting notes

Annexe 5: Memorandum of Appointment dated 23 March 2009

Financial Services Authority

MEMORANDUM OF APPOINTMENT OF INVESTIGATORS

The Financial Services Authority of 25 The North Colonnade, Canary Wharf, London E14 5HS (the FSA) hereby appoints Mr Jones, 3 Associates and 1 paralegal in the Enforcement Division (the investigators) to conduct an investigation on its behalf into Peter Cummings.

RELEVANT PROVISIONS

The investigators are appointed under section 168(5) of the Financial Services and Markets Act 2000 (the Act} as a result of sections 168(4)(d) and 168(4)(i) of the Act.

REASONS

The reasons for the appointment under section 168(5) are that it appears to the FSA that there are circumstances suggesting that Mr Cummings;

1. may be guilty of misconduct for the purposes of section 66 of the Act; and/or

2. may not be a fit and proper person to perform functions in relation to a regulated activity carried on by an authorised or exempt person.

In particular there are reasons to suggest that whilst performing his controlled function Mr Cummings may have failed to comply with one or more of the Statements of Principle issued by the FSA under section 64 of-the Act by:

The Financial Services Authority
25 The North Colonnade, Canary Wharf, London, E14 5HS United Kingdom
Telephone +44 (0)20 7066 1000 Fax +44 (0)20 7066 1099
www.fsa.gov.uk

1. failing to take reasonable steps to ensure that the business of the firm for which he was responsible in his controlled function was organised so that it could be controlled effectively (Statement of Principle 5);

2. failing to exercise due skill, care and diligence in managing the business of the firm for which he was responsible in his controlled function (Statement of Principle 6); and/or

3. failing to take reasonable steps to ensure that the business of the firm: for which he was responsible in his controlled function complied with the relevant requirements of the regulatory system (Statement of Principle 7).

The circumstances suggesting that Mr Cummings may have failed to comply with one or more of the FSA's Statements of Principle and/or may not be a fit and proper person are as follows:

1. Mr Cummings held the FSA's director controlled function (CF1) at Bank of Scotland Plc from 1 January '2006- 16 January 2009 (the Relevant Period). He performed this controlled function in his role as an executive director of HBOS P1c and as Chief Executive of HBOS Plc's Corporate Division (the Corporate Division).

2. As Chief Executive of the Corporate Division, during the Relevant Period Mr Cummings was responsible for managing HBOS Plc's exposure to credit risk arising from corporate lending transactions.

3. It appears that the credit risk related systems and controls for which Mr Cummings was responsible were not effective. Mr Cummings' conduct in this regard appears to have caused or contributed to the significant impairment charges incurred on HB0S Plc's corporate book for the year end 2008.

Signed [redacted] Dated Monday, 23 March 2009

[Mr Walker]
Head of Department
Enforcement Division

For and on Behalf of the FSA

Annexe 6: ExCo Summary Paper dated 25 April 2012

EXCO SUMMARY PAPER

Subject	PROJECT HAVANA: ACTION AGAINST INDIVIDUALS
Date of meeting	25 April 2012
ExCo sponsor	Tracey McDermott
Sign-off	Has the ExCo sponsor approved the paper? YES
Author(s)	Mr Walker; Associate, Enforcement
Purpose of agenda item	For Decision
Executive Summary	On 9 March 2012, the FSA issued a public censure to Bank of Scotland plc in relation to the failings of its Corporate Division in the period 2006 to 2008. This outcome against the firm is closely related to the enforcement investigation into the conduct of Peter Cummings (former HBOS executive director and Chief Executive of Corporate) that was started in March 2009 as part of the wider Project Havana. Mr Cummings is the only former HBOS senior officer that we are currently taking enforcement action against in relation to the failure of HBOS. Cummings' proceedings are at an advanced stage through the FSA's Regulatory Decisions Committee (RDC). During the course of the Cummings investigation, Enforcement kept under review the position of other former HBOS senior officers, including Andy Hornby, Group Chief Executive. After careful consideration, we decided not to place Hornby under investigation as we concluded that such an investigation had very limited prospects of success. We remain of this view having considered this afresh. Our focus in reaching this decision was on Hornby's oversight of Corporate matters: we did not consider his conduct in overseeing issues faced by other divisions (e.g. Retail or International) or group issues relating to funding and liquidity, which were not covered by our work. It is likely that the FSA is now time barred from taking disciplinary action against Hornby or any other individuals who may be guilty of competence related misconduct linked to the failure of HBOS. If the FSA has concerns that any individuals lack competence and capability and continue to pose a threat to the FSA's regulatory objectives, it remains open to us to investigate them with a view to seeking a prohibition order against them and/or the withdrawal of any approvals that they currently hold. To take such action we would need to establish that they were so incompetent as to be not fit and proper. The possible investigations we think we could realistically pursue would be into other individuals in Group Risk (Dan Watkins and Peter Hickman) and Group Finance (Phil Hodkinson and Mike Ellis) in relation to failings in Corporate, or into Hornby or others in relation to potential failings in the retail bank and HBOS's funding position.

	Commencing a further investigation now would face significant additional challenges in terms of evidence gathering given the passage of time. It would also, as with all senior management cases, have a relatively low prospect of success. Our motivation for doing so would undoubtedly be questioned. It would also inevitably delay any HBOS report. An alternative to commencing a fresh enforcement investigation now, and the potential impact this would have on a report into why HBOS failed, would be to consider any material identified in a report into the failure and keep the question of whether further enforcement action is warranted under review. If we decide that no enforcement action is appropriate (and in any event in the interim) we can seek to rely on the authorisations process to prevent former senior managers at HBOS from taking SIF roles. The attached schedule sets out details of former HBOS directors who currently hold controlled functions. Depending on what is decided, when we reach the stage where we are seeking to either publicise a decision notice on Cummings or a decision to take no further action against him, consideration will need to be given to what we should say publicly about our stance on other individuals.
What is the intended outcome?	To ensure the FSA's ongoing work in relation to the failure of HBOS remains appropriately and proportionately focused.
Proposed ExCo decision	Whether to : • start an enforcement investigation into Andy Hornby and/or other former HBOS senior officers now; or • keep the position under review pending further work relating to the report on why HBOS failed.
GCD views	GCD sign-off not required as the issues relate to the exercise of Enforcement powers. Ms Evans, Chief Litigation Counsel in Enforcement Legal, has approved this paper.
Equality & diversity implications	No opportunities to eliminate discrimination and promote equality and good relations have been identified.
History	Periodic updates to ExCo, including on 21 September 2010 as to enforcement's decision not to take enforcement action against Hornby or Stevenson.
Follow-up	Updates will continue to be provided on a periodic basis as to the progress of this matter.

Background

Scope of Project Havana

1. Our work on Project Havana began in March 2009 and involved two workstreams:

    a) An enforcement investigation into the conduct of Peter Cummings, the former Chief Executive of HBOS's Corporate Division.[1] The decision to refer Mr Cummings to Enforcement was based on concerns regarding the adequacy of the Corporate Division's management and control of credit risk prior to and during the financial crisis; and

    b) A 'supervisory review' of financial disclosures made in the prospectuses that HBOS sent to shareholders in relation to its June 2008 rights issue and November 2008 placing and open offer. This was prompted by concerns regarding the unprecedented scale and escalation of impairment losses disclosed for HBOS by year end 2008. This workstream was led by Enforcement using powers under section 165 of FSMA. It was aimed at identifying any issues warranting more detailed investigation through the formal appointment of enforcement investigators.

2. Although Mr Cummings was the only individual referred to Enforcement, we kept the roles and conduct of other former HBOS senior officers under review during the course of the project (see further below).

Peter Cummings

3. Following detailed investigation, Enforcement concluded that Mr Cummings breached Statement of Principle 6 by failing to act with due skill, care and diligence in relation to the Corporate Division's:

    a) pursuit of a high risk and aggressive growth strategy despite known weaknesses in its control framework, between January 2006 and March 2008; and

    b) management of high value transactions which showed signs of stress, between April and December 2008.

4. The RDC issued a Warning Notice to Mr Cummings on 3 June 2011 proposing a financial penalty of £1 million and a prohibition order preventing him from performing a SIF function at any systemically important firm in the future. Mr Cummings' oral representations meeting took place on 8 March 2012 and we are currently awaiting the RDC's decision (expected by mid-May).

5. Ernst & Young assisted us with information gathering and analysis in the early stages of the investigation. However, while some of Ernst & Young's work was helpful and fed into documents that we prepared for the RDC, their role in the Cummings investigation was not as extensive as PwC's role in relation to RBS.

Bank of Scotland plc

[1] Mr Cummings held the FSA's director controlled function (CF1) as an Executive Director of HBOS from 1 January 2006 to 16 January 2009.

6. After the completion of the Cummings investigation, and as a result of our assessment of the evidence gathered in that investigation, the decision was made to also take action against the firm for breach of Principle 3. Settlement was reached with the firm shortly before it was due to make oral representations to the RDC, with a public censure and press release issued on 9 March 2012. The firm's Final Notice covers the same failings at Corporate level that are the subject of the Cummings Warning Notice. It also includes criticism of the firm's Group Risk and Group Internal Audit functions.

HBOS capital raisings

7. The majority of the underlying work and analysis relating to the capital raisings review was carried out by Ernst & Young. Ernst & Young's work called into question the adequacy of management information relating to impairment losses on the corporate book that fed into the public disclosures made in 2008. Given that a key part of the case against Mr Cummings related to the Corporate Division's slow recognition and reporting of stressed assets in the period April to December 2008, we decided to take this issue forward as part of the existing enforcement investigations.

8. Enforcement considered the possibility that the firm's conduct in relation to its reporting of impaired assets for Corporate may have breached the Prospectus and Listings Rules. However, we concluded that any such breaches could not be pursued and/or did not warrant further enforcement action. A brief paper relating to our consideration of Prospectus and Listing Rules issues was provided to ExCo ahead of its meeting on 14 April 2011 (see copy attached). Any such action is now time barred.

Action against other individuals: legal issues

9. Enforcement has found no evidence to suggest that any former HBOS senior officers (including Mr Cummings) acted deliberately in breach of FSA rules or with a lack of integrity in relation to the matters that are the subject of the firm's Final Notice: our case against Cummings is that he failed to act with due skill, care and diligence.

10. Disciplinary cases alleging that senior managers in large firms have failed to act with due skill, care and diligence are particularly challenging. A key reason for this is the need to establish personal culpability. Further, in such cases a strict statutory limitation regime applies, requiring a Warning Notice to be issued within three years of the date that the FSA first knew of the misconduct.

11. It is highly likely that the FSA is now time-barred from taking disciplinary action against anyone other than Cummings for competence related misconduct linked to the failure of HBOS.

12. However, if we have concerns that former HBOS senior officers lack competence and capability and continue to pose a threat to the FSA's regulatory objectives, it remains open to us to investigate them. If appropriate, the FSA could then seek to prohibit the individuals in question and/or withdraw any approvals that they currently hold.

13. The evidential threshold for starting an enforcement investigation is relatively low. However, the fact that an individual held a significant influence function at a failed firm will not of itself be sufficient to establish that the person should be prohibited. Seeking to

prohibit a senior manager at a large firm on grounds that they lack competence and capability is likely to be particularly challenging.

14. The risk that an individual that we have concerns about may secure a high profile role in the financial services sector may also be mitigated through the authorisations process. All authorisation applications must be considered on their individual merits and any decision to reject an application will of course be subject to due process. Keeping people out of the industry where there has been no investigation and finding of misconduct made against them can be difficult, although it is somewhat easier than taking disciplinary action. We have flagged with Intelligence the names all individuals who were directors of HBOS in the period January 2006 to December 2008 (a schedule with details of these individuals including details of any controlled functions that they currently hold is attached to this paper), and any authorisation applications relating to any of these individuals will be subject to particularly careful consideration.

Enforcement's assessment of other individuals

15. In the course of Project Havana, we obtained information about the roles that other former HBOS senior officers played in overseeing the Corporate Division. Although our primary focus was on the case against Cummings, we kept under review whether our scope should be extended to include other individuals.

16. Specifically, mid-way through our investigation into Cummings, we conducted a review of evidence that we had gathered regarding Andy Hornby, as Group Chief Executive and Cummings' line manager. We describe below our assessment of Hornby and a number of other prominent individuals at HBOS. However, it is important to keep in mind the limited scope of our work in that:

    a) we have not considered in detail any matters pre-2006;

    b) our focus in assessing other individuals was on their oversight of Corporate: we did not investigate other divisions within HBOS or the wider reasons behind HBOS's failure, for example issues around funding and liquidity.

Andy Hornby

17. Andy Hornby was made Chief Executive of Halifax's Retail Division in 1999 and became Chief Executive of HBOS's Retail Division when it was created in 2001. In July 2005 he became HBOS's Chief Operating Officer. He then took over from James Crosby (see below) as Group Chief Executive of HBOS during H1 2006 and remained in this post until the firm's acquisition by Lloyds in January 2009.[2]

18. Although Hornby's conduct was not specifically within our scope, we did closely examine his role in overseeing Corporate matters in Q1 2010, with assistance from Ernst & Young. We concluded that, while the threshold for starting an investigation into his oversight of Corporate was met, we were unlikely to succeed in establishing personal culpability against him. The decision was therefore taken not to formally start an investigation into his conduct and to continue to focus on taking forward the case against Cummings.

[2] Hornby held CF1 throughout his time at HBOS, and CF3 (chief executive) & 8 (apportionment and oversight) from March 2006 until his departure in January 2009.

19. In reaching this conclusion, we took into account the key roles at Group level also played by the central control functions and Board committees, and the firm's federal structure. HBOS's federal structure gave Cummings and other divisional chief executives significant autonomy in how they ran their businesses. It also meant that primary responsibility for risk management lay within the 'first line of defence' at divisional level. While it is clear that Hornby and other former HBOS senior officers[3] put pressure on Cummings to increase Corporate's profitability to make up for the under performance of Retail, Cummings was in a unique position to understand and advise his colleagues on ExCo and the Board about the risks inherent in the corporate book and the deficiencies in the division's control environment. Our case against Cummings is that he did not do this adequately. Instead, he expressed confidence to ExCo and the Board that the credit fundamentals of Corporate's portfolio were sound in justifying his strategy of 'lending through the cycle'. The independent expert in the Cummings case, Bob Scanlon (Chief Risk Officer at Standard Chartered[4]), is particularly critical of this strategy given the deficiencies in Corporate's systems and controls and the high risk profile of its book.

20. During the investigation and RDC process, [redacted][5] He has done this by reference to:

    a) [redacted] (as mentioned above); and

    b) the evidence of Cummings' former Chief Risk Officer, Stewart Livingston, who singled out Hornby in interview as having been particularly aggressive towards him and his team at a meeting relating to Corporate's provisioning levels in late in 2008.[7] This meeting was attended by a number of members of HBOS's senior management team (including Cummings).

21. We interviewed Hornby for the purposes of the Cummings investigation in May 2010. He sought to play down the rate of Corporate's growth, noting that growth in 2006 and 2007 was the continuation of a trend that pre-dated his time as CEO and maintaining that significant profits were generated as a result of attempts to de-risk the corporate book by selling investments. He also denied detailed knowledge of issues impacting Corporate's control environment. In relation to discussions around provisioning decisions in late 2008, Hornby recalled the highly pressurised context in which such discussions were held given the issues facing the bank at that time. He also placed significant reliance on comments made by KPMG regarding the adequacy of the firm's *overall* provisions. More generally, Hornby emphasised how he placed significant reliance on Cummings' expertise in corporate banking matters given that his own experience was in retail banking. He also noted that his primary focus during the relevant period was other areas of the Group, in particular Retail (given the concerns about the firm's exposure to a

[3] Cummings specifically cited Phil Hodkinson, HBOS's Group Finance Director at the time (see further below).
[4] In obtaining Mr Scanlon's consent for publication he pointed out that his correct title was Group Chief Credit Officer at Standard Chartered
[5] This text has been redacted because it contains information for which consent to disclosure was required from Mr Cummings; that consent was not received.
[6] This text has been redacted because it contains information for which consent to disclosure was required from Mr Cummings; that consent was not received.
[7] Consent for publication has been received by Mr Livingston in regard to this extract of the document on the condition that it is made clear that this document is a contemporaneous internal FSA document and as such all statements are direct quotations from the FSA.

downturn in the residential housing market), International (a new division that was key strategic growth area for the firm, with a particular focus on Australia) and Treasury (given the historical funding issues that the firm was seeking to improve).

22. Although there are some areas of Hornby's evidence in interview that we do not accept (e.g. we do not accept that Cummings ever actively sought to, or did, de-risk his book though investment disposals) we were generally satisfied by the answers that he gave in seeking to explain his oversight of Corporate in the context of HBOS's federal structure, and in response to the specific allegations made against him by Cummings and Livingston.[8] We remain firmly of the view that the most culpable senior manager for the Corporate Division's failings is Cummings. We note that Hornby's reliance on Cummings' corporate banking expertise was not, on the face of it, obviously unreasonable and, as is clear from the Pottage decision, this is a factor which the Upper Tribunal would be likely to take into account in his favour.

23. Andy Hornby is not currently an FSA approved person. Since leaving HBOS he has served as Chief Executive of Alliance Boots from July 2009 to March 2011, and Chief Executive of Coral from July 2011 to date.

Lord Stevenson

24. Dennis Stevenson was made Chairman of Halifax in 1999 and became Chairman of HBOS when it was created in 2001. He remained in this role until the firm was acquired by Lloyds in January 2009.[9]

25. We interviewed Stevenson for the purposes of the Cummings investigation in May 2010. In interview, he emphasised the limitations in his ability to oversee and influence Corporate strategy given the non-executive and part time nature of his role. He also explained how he placed significant reliance on Board committees to oversee the divisional matters from an operational perspective within HBOS's federal structure. In particular, he believed that governance arrangements in place at HBOS for independent oversight of the executive (through the Audit Committee supported by Risk Control Committees for each division) were robust.

26. No evidence came to light in Stevenson's interview (or otherwise in our investigation) to make us consider recommending that he be placed under investigation in relation to Corporate's failings. Corporate provided monthly MI to the Board detailing all advances to customers over £75 million, and strategic papers relating to Corporate were presented to the Board once or twice a year. However, we accept Stevenson's explanation that, as a non-executive director, his knowledge of issues affecting the Corporate Division was high level in nature. Moreover, as noted above, Cummings expressed confidence to the Board that the credit fundamentals of Corporate's portfolio were sound.

27. Although Cummings' competence as a CF1 is now under scrutiny, any criticism of his appointment to the Board or as Chief Executive of Corporate would be with the benefit of hindsight. Cummings had a strong track record at the firm prior to the financial crisis,

[8] Consent for publication has been received by Mr Livingston in regard to this extract of the document on the condition that it is made clear that this document is a contemporaneous internal FSA document and as such all statements are direct quotations from the FSA.
[9] Stevenson held the FSA's non-executive director controlled function (CF2) throughout his time as Chairmen of HBOS.

and the Board placed significant reliance on his experience and expertise as a corporate banker. His status as the highest paid member of the Board reflected this.

28. Since June 2007, Lord Stevenson has held CF2 as a non-executive director at Loudwater Investment Partners Limited (an investment firm that specialises in later stage private growth companies in the UK and US).

Sir James Crosby

29. James Crosby was made Chief Executive of Halifax in 1999 and became Chief Executive of HBOS when it was created in 2001. In January 2006 he announced his resignation and left the firm in July 2006.[10] He was also a non-executive director of the FSA from January 2004 until February 2009 when he resigned following allegations made by Paul Moore (Head of Group Regulatory Risk at HBOS from 2002 to 2005) to the Treasury Select Committee.

30. Given that he resigned from HBOS at the start of 2006, James Crosby's conduct did not feature in our work and no evidence came to light in our investigations to make us consider recommending that he be placed under investigation.

31. James Crosby is not currently an FSA approved person. However, he is currently Chairman of Misys (a company which provides software and services to the financial services sector) and MoneyBarn (an online car finance company, which may become regulated by the FCA when consumer credit transfers).

Other individuals

32. Given the nature of our findings against the firm as described in the Final Notice, we have considered the potential culpability of members of HBOS's senior management team responsible for its Group Risk, Group Internal Audit and Group Finance functions.

33. In relation to Group Risk, the Final Notice refers to its failure to conduct effective oversight and control of Corporate. HBOS's Group Risk Director was a member of ExCo but not the Board. There were two main individuals that held the position of Group Risk Director during the relevant period: Dan Watkins (from February 2006 to September 2007) and Peter Hickman (from September 2007 onwards). Our findings in relation to Group Risk may be attributed to HBOS's federal structure, which led to a concentration of credit risk knowledge and expertise within Corporate and made it difficult for Group Risk staff to provide effective challenge to their counterparts in the business. Given, however, the significant responsibilities for risk management that were formally delegated to the Group Risk Director by the Board, and the slow progress that was made in developing an effective process for setting risk appetite across the group during the relevant period, the threshold for starting investigations into the conduct of both Watkins and Hickman in relation to Corporate's failings would certainly be met. However, establishing personal culpability may be challenging in particular given that the balance of power at the firm in practice rested with the business (i.e. Cummings). The handover period between Watkins and Hickman in 2007 would be an additional complication in seeking to take action against them.

[10] Crosby held CF1, 3 and 8 throughout his time at HBOS.

34. In relation to Group Internal Audit, the Final Notice refers to issues with the quality and scope of assurance work that it undertook in connection with Corporate. The Head of Group Internal Audit for throughout the relevant period was David Fryatt. Group Internal Audit reported to the Audit Committee, but came under the remit of the Group Finance Director for 'pay and rations'. We did not find any specific failings in relation to the Group Internal Audit function as a whole. The issues relating to the team that was assigned to Corporate (i.e. as regards its expertise and resources, and insufficient focus on business as usual matters) do not indicate personal culpability on the part of any one senior individual.

35. Although the Group Finance function is not expressly criticised in the Final Notice, the Group Finance Director had an influential role at the firm during the relevant period, working closely alongside Andy Hornby. Two individuals held this position during the relevant period: Phil Hodkinson (from the start of the period until September 2007)[11] and Mike Ellis (from September 2007[12] onwards).[13] We did not formally interview either Hodkinson or Ellis during the course of the investigation. However, we obtained information about their roles from other sources, including from Cummings and other witnesses. Hodkinson was involved in key discussions concerning the setting of Corporate's growth targets and Ellis was involved in key discussions regarding Corporate's provisions. The comments made above regarding Hornby's conduct in relation to Corporate's aggressive growth, apply equally to Hodkinson. As regards provisioning issues, the onus was arguably more on Ellis to ensure that the correct figures for Corporate impairments were identified and reported up to Group, than on Hornby. However, establishing personal culpability may be challenging given the fact that KPMG signed-off the Group's overall provisioning levels and that [redacted][14]

Pros and cons of pursuing other individuals

36. If the scope of Project Havana is to be extended to another individual, the most obvious candidate would be Andy Hornby (followed probably by Dan Watkins and Peter Hickman, and then Mike Ellis and Phil Hodkinson). While we have a sufficiently clear understanding of Hornby's role in relation to Corporate matters, we do not have a detailed understanding of how he oversaw other divisions or how he dealt with the funding and liquidity issues that the firm faced prior to and during the financial crisis. Given the apparent significance of funding and liquidity issues to the failure of HBOS, it would not be difficult to establish that the relatively low threshold for starting an investigation into such issues has been met.

37. However, although taking such a step may enable us to send out a further strong message to the industry about the high standards that the FSA expects of Chief Executives at large firms, we consider that there are significant disadvantages to starting such an investigation at this stage. In particular:

[11] Hodkinson currently holds CF2 at a number of companies within the Friends Life group. He also holds CF2 at Winterthur Life (UK) Limited.
[12] During the consent for publication process it was pointed out that although Mr Ellis rejoined HBOS in September 2007 he only formerly became Group FD in January 2008.
[13] Ellis currently holds CF2 as Chairman of Skipton Building Society.
[14] This text has been redacted because it contains information for which consent to disclosure was required from Mr Cummings; that consent was not received.

a) to establish that Hornby should be prohibited, we would need to identify and evidence very serious competence and capability failings on his part: to illustrate this, it is worth noting that while the RDC considered the oversight failings of John Pottage (the Wealth Management CEO at UBS) were sufficiently serious to warrant a significant financial penalty, they did not seek to prohibit him, and the Upper Tribunal has, ultimately, decided no penalty should be imposed;

b) as these issues were beyond the scope of Project Havana, they will require significant further resource intensive investigation with a material risk of no successful outcome;

c) the overlap between any investigation into Hornby focusing on funding issues and the subject matter of the FSA's report on why HBOS failed may impact on the FSA's ability to progress either or both of these workstreams;

d) Hornby would be expected to challenge any outcome with the consequent further delays involved;

e) there is a risk that the investigation will complicate the Cummings proceedings i.e. in the event the RDC gives him a decision notice and he refers it to the Upper Tribunal.

38. The above or similar disadvantages would also apply to consideration of any fresh investigations at this stage into the conduct of other former HBOS senior officers.

39. A number of the above disadvantages may be mitigated by the deferral of any decision to investigate Hornby (and/or others) until work on the report into why HBOS failed has identified evidence on areas such as the bank's retail business and funding position. If the report does not, because of its scope or focus, uncover sufficient evidence for us to make decision on enforcement action, we can continue to seek to mitigate any concerns that Hornby, or any other former senior officer at HBOS, may secure a role in the financial services sector through the authorisations process.

Recommendation

40. We recommend that no further enforcement investigations are started into other individuals in respect of Corporate failings.

41. However, in respect of the retail bank and HBOS's funding position, the situation is less clear: we recommend that a decision on this is kept under review while the report into why HBOS failed is taken forward. If that report identifies evidence suggesting personal culpability on the part of Hornby or others further action could be taken.

APPENDIX: PROSPECTUS AND LISTING RULES ISSUES

1. The FSA commissioned Ernst & Young (EY) to undertake a review into the various public disclosures made by HBOS Group in 2008, including the reporting of impaired assets by the Corporate Division. Following that review, Enforcement consider that breaches of the Prospectus and Listing Rules cannot be pursued, and it is not proposed to take any further action in relation to this issue.

2. Any allegation that the level of impairment had been understated would rely on showing that this was material to the financial position of the Group as a whole: effectively, this would require a wholesale re-working, not only of the Corporate loan book, but also of the Group's financial statements.

3. More generally, even if this substantial work was undertaken, it is thought unlikely that we would be able to show that HBOS failed to discharge its obligations given that it:

   (1) obtained the sign-off of the reporting accountants (KPMG) and its other advisers;

   (2) obtained the sign-off of the Audit Committee; and

   (3) advised the FSA of the approach taken to provisioning and impairments.

4. It should also be noted that disclosures made to the market included warnings in respect of HBOS Corporate's loan book: for example, the prospectus issued by Lloyds TSB immediately prior to the acquisition noted that, if the economic downturn were to continue, "the Enlarged Group's corporate lending portfolios are likely to generate substantial increases in impairment losses."

5. It is considered, therefore, that no action should be brought in respect of the Prospectus and Listing Rules.

6. It should also be noted that FSMA imposes a two year time limit for bringing proceedings under the Listings Rules. It is highly likely that we are already time-barred. There is no limitation period for taking similar action under the FSA's market abuse regime. However, any such action would face similar legal and evidential hurdles to those outlined above, and it is not proposed to take this course.

7. Should the Peter Cummings investigation (or a new HBOS investigation into its failure) result in a public outcome, there may be criticism, for example from the Lloyds Action Now Group, that the FSA has not also taken action in respect of alleged misstatements in prospectuses. These criticisms may be heightened where, for example, Mr Cummings is criticised in respect of the risk of slow identification of impairments. However, based on the evidence uncovered in the investigation to date, we are confident that such criticism would not be well founded, and could be set in context in any public statements we make.

No.	Director	Role at HBOS in period 2006 to 2008	Dates as director of HBOS	Currently FSA Approved?
1.	Richard Cousins	Non-executive Director	28 March 2007 to 16 January 2009	
2.	Sir James Crosby	Executive Director; Chief Executive	1 December 2001 to 31 July 2006	
3.	Peter Cummings	Executive Director; Chief Executive Corporate Division	1 January 2006 to 16 January 2009	
4.	Jo Dawson	Executive Director; Chief Executive Insurance and Investment Division	1 May 2006 to 13 January 2010	
5.	Charles Dunstone	Non-executive Director	1 December 2001 to 29 April 2008	CF4 Partner at Clareville Capital Partners LLP (since 1 July 2009)
6.	Mike Ellis	Executive Director; Group Finance Director	25 September 2007 to 16 January 2009	CF2 Non-executive Director Skipton Building Society (since 16 June 2011)
7.	Sir Ron Garrick	Non-executive Director	1 December 2001 to 16 January 2009	
8.	Philip Gore-Randall	Executive Director; Chief Operating Officer	15 September 2007 to 2 April 2009	
9.	Benny Higgins	Executive Director; Chief Executive Retail Division	1 May 2006 to 10 August 2007	CF1 Director Tesco Personal Finance PLC, CF3 Chief Executive Tesco Personal Finance PLC (both since 18 December 2008)
10	Tony Hobson	Non-executive Director	1 January 2001 to 16 January 2009	CF2 Non-executive Director esure Insurance Limited (since 5 November 2003)
11	Philip Hodkinson	Executive Director; Group	1 December 2001 to 31 December 2007	CF2 Non-executive Director at Friends Life Assurance Society Limited (since 15 September 2010), Friends Life Limited

		Finance Director		(since 17 November 2009), Winterthur Life (UK) Limited (since 30 November 2011), Friends Life Company Limited (since 15 September 2010) and Friends Life and Pensions Limited (since 17 November 2009)
12	Andy Hornby	Executive Director; Chief Executive	1 December 2001 to 16 January 2009	
13	Sir Brian Ivory	Non-executive Director	1 December 2001 to 25 April 2007	CF2 Non-executive Director Arcus European Infrastructure Fund GP LLP (since 19 May 2010), Shawbrook Bank Limited (since 20 April 2011), Insight Investment Funds Management Ltd (since 28 September 2005), Insight Investment Management (Global) Limited (since 28 September 2005)
14	Karen Jones	Non-executive Director	1 January 2006 to 16 January 2009	
15	John E Mack	Non-executive Director	30 April 2007 to 16 January 2009	
16	Colin Matthew	Executive Director; Chief Executive Strategy & International	1 December 2001 to 16 January 2009	
17	Coline McConville	Non-executive Director	1 December 2001 to 16 January 2009	
18	Kate Nealon	Non-executive Director	23 February 2004 to 16 January 2009	
19	David Shearer	Non-executive Director	23 February 2004 to 25 April 2007	CF2 Non-executive Director Martin Currie Investment Management Ltd (since 12 March 2008), Martin Currie Inc (since 26 November 2009)
20	Lord Dennis Stevenson	Non-executive Director; Chairman	1 December 2001 to 16 January 2009	CF2 Non-executive Director Loudwater Investment Partners Limited (since 20 June 2007)
21	Dan Watkins	Executive Director; Chief Executive Retail Products	5 September 2007 to 8 April 2009	