



24th July 2009

Dear Complainant,

Complaint against the Financial Services Authority Our Reference GE-L0969

I write with reference to your letters to my office in connection with your complaint against the Financial Services Authority (FSA) and Firm A's recent rights issue.

At this stage I think it would be worth explaining my role and powers. Under the Complaints Scheme (Complaints against the FSA-known as COAF) my role is as an independent reviewer of the FSA's handling of complaints. I have no power to enforce any decision or action upon the FSA. My power is limited to setting out my position on your complaint based on its merits and then if I deem it necessary I can make recommendations to the FSA. Such recommendations are not binding on the FSA and the FSA is at liberty not to accept them. Full details of Complaint Scheme can be found on the internet at the following website; <http://fsahandbook.info/FSA/html/handbook/COAF>.

Your Complaint

In your letter you sent to my office on 19th January 2009 I understand that your complaint related to the following:

1. You believe that the FSA was aware that there were 'problems' with Firm A and failed to take action to protect consumers by allowing it to proceed with a rights issue.
2. You have also questioned whether the FSA prevented Firm A from releasing full details about its financial position to shareholders prior to the rights issue and the shareholder vote on its merger with Firm B (to form the Group C).
3. You have also questioned why shareholders are given less protection than members of a pension scheme.

On 11th and 13th February 2009 you added a further element to the complaint you wanted me to investigate:

4. You felt that the FSA did not act upon warnings given to it by Mr X, Firm A's former head of Group Regulatory Risk, in late 2004. Although it was reported that the FSA considered these warnings you would like to know what the FSA did as, in your opinion, you did not feel that sufficient attention was paid.

On 4th April 2009, and again on 12th May 2009, you added two further elements to the complaints you wanted me to investigate as you felt that the FSA's investigation and response into element four of your complaint (as shown above) was insufficient and hid behind the confidentiality section of the Act (section 348).

5. You feel that in light of the publicity surrounding the 'failure' of Firm A the FSA should disclose exactly what concerns it had about Firm A both before and after Mr X's allegations together full details of its investigation into Mr X's allegations.
6. You raised also concerns over the FSA's supervision of Firm A in relation to its risk model and feel that not enough pressure was applied to its management in light of the concerns it obviously had.

My Position

As part of my investigation into your concerns I have obtained and reviewed the FSA's investigation file. When considering your complaint I have considered the information you have provided, the information contained in the FSA's file and the additional information I have requested from the FSA together with the arguments you have made when corresponding with the FSA and my office. I also have to have regard to the rules of the complaints scheme, put in place by Parliament by means of a statutory instrument so that my office has a statutory function, when considering what I can and cannot consider.

From the information you have provided I understand that in June 2008 you were invited to attend a presentation by Firm A which was aimed at encouraging existing shareholders to take advantage of the forthcoming rights issue and purchase the additional shares they were being offered. Although you say you were concerned over the fact that the option price was higher than the current trading below the option price, you say you were reassured by the Firm A staff present that this was not a cause for concern and, based on this assurance, subsequently purchased all of the shares allocated to you under the option.

After you had exercised your options, and purchased additional Firm A shares, it became clear that there were concerns over the financial stability of Firm A which ultimately resulted in its merger with Firm B (to form Group C). As it became clear that there were concerns over the operating model Firm A had adopted before the rights options was announced you feel that the FSA should have acted to protect shareholders and prevented Firm A from offering additional shares under the rights issue.

As part of my investigation I have asked the FSA to confirm what enquiries it made both internally and with the firm before authorising the rights issue. I have also obtained and reviewed the prospectus issued to existing shareholders in relation to the rights issue.

From my investigations I am satisfied that the FSA adequately considered the matter and that the requisite threshold conditions for authorising the rights issue were met. I am also satisfied that the FSA followed the standard and correct procedures in allowing the rights issue to take proceed. Likewise I am also satisfied that the prospectus clearly indicates that the purchase of (additional) shares carried a risk and that should financial conditions turn against Firm A then shareholders could potentially lose all or part of the value of their investment. This information is contained in Part II of the prospectus (pages 10 to 16). I have enclosed copies of the relevant pages from the prospectus as Appendix 1 at the end of this letter.

Although I accept that Firm A 'collapsed' within six months of the rights issue taking place, this does not in turn mean that the FSA was wrong in allowing Firm A to conduct the rights issue. As I have previously explained, the FSA considered a number of factors which could affect the long term future of the firm before it authorised the rights issue. Whilst, in this case, the FSA was unable to stop the 'collapse' of the bank, from the information provided to me there is nothing to indicate that the FSA was in possession of information at the time that it approved the rights issue which showed that the bank *would* (my emphasis) 'collapse' within the foreseeable future.

I appreciate that you also feel that shareholders are treated differently to members of a pension fund as, should a pension fund collapse, its members do, to an extent, receive additional protection by way of the Financial Services Compensation Scheme, which is funded through a levy being placed on the fund provider. Whilst it is true that pension fund members do receive additional protection, the nature of the two 'investments' are very different, as is the manner in which they are purchased. Pension products are usually purchased through financial advisers (generally on an advice basis) whereas shares are purchased through a broker (usually on a non-advice/execution only basis).

Pension fund members purchase units within a fund which is operated by firms authorised and supervised by the FSA. Whilst a pension fund's underlying investments may include shares, these shares do not automatically convey voting rights or an entitlement to dividends to the pension fund member. Whereas, with the purchase of shares, a shareholder usually receives both voting rights and an entitlement to future dividend (if one is paid) following the purchase.

Although all listed companies have to operate within certain guidelines, unless the listed firm operates in the financial services sector there is no requirement for its day to day operations to be regulated by the FSA. Similarly, whilst a FSA regulated company may be listed on a UK market it would not be possible for shareholders holdings to be offered protection as it would be inappropriate to differentiate between the shares held in firms operating in the financial services arena with those operating in other market sectors such as construction or utilities.

Likewise, I am also satisfied that the FSA took the appropriate action following the allegations made by its former head of its Group Regulatory Risk in late 2004. When Mr X made these allegations it appears that Firm A discussed them with the FSA. Following discussions with the FSA (and after obtaining the FSA's agreement), Firm A instructed Auditor D to undertake an external investigation into Mr X's claims. Once Auditor D had conducted its investigation it produced a substantive report which detailed its findings and presented this to both Firm A's board and the FSA in April 2005.

I note in your letter of 12th May 2009 that you highlight that this report was considered confidential and I can confirm that, at the time of its release it was, and was viewed only by the Firm A board and staff from the FSA. However, in light of the media coverage surrounding the 'collapse' of Firm A and the subsequent enquiry undertaken by Parliament's Treasury Select Committee, the report was made public.

I appreciate from your letter to my office of 12th May 2009 that you feel that as Auditor D were Firm A' auditors it should not have conducted the investigation. When considering this, I would draw your attention to the statement released by the FSA on 11th February 2009 which states that prior to Auditor D starting its investigation into these allegations, the FSA satisfied itself about the "*skill and independence of the individuals selected to conduct the report for Auditor D and about the scope of the report*". Although this can be found on the internet at www.fsa.gov.uk/pages/Library/Communication/Statements/2009/letter_chancellor.shtml, I have enclosed a copy of the statement as Appendix 2 at the end of this letter. As such I am satisfied that the FSA took sufficient and reasonable steps to ensure the independence of the people conducting the investigation and that there was not a conflict of interests.

I have also noted your comments that Auditor D's investigation and report does not address Mr X's specific allegations of risk taking by Firm A. Whilst I agree that the report does not do this, I must point out that this was not within the scope of Auditor D's investigation nor do I believe that it should have been. As can be seen from the FSA's 11th February 2009 statement (and other media articles) the level of risk which Firm A was taking was something which the FSA was *already* (my emphasis) in discussions with it (and had been since a routine risk assessment audit which was carried out in 2002) and was something which it was closely monitoring with the firm.

This statement also provides details of the concerns the FSA had about Firm A both before and after Mr X made his allegations. This statement provides full details of the action the FSA took to try to reduce the group risk and ensure that the risks posed by the group's growth strategy was managed and mitigated. As further details of the action taken by the FSA can be found in the FSA's statement I do not intend to make any further comment here.

I would also add that, whilst you say that the FSA did not take sufficient action to ensure that Firm A lowered its risk profile, you have not provided sufficient, if any, evidence to show that the decisions taken by the FSA either at the time or subsequently were either unreasonable or incorrect based on the information the FSA had within its possession. Unless you can provide sufficient evidence to show that the decisions the FSA took were either incorrect or unreasonable, based on the information it had at the time, then in accordance with paragraph 1.4.2A of COAF I cannot make any further comment or undertake further investigations into this particular element (element five) of your complaint. Paragraph 1.4.2A of COAF states:

COAF 1.4.2 A Circumstances under which the FSA will not investigate

The *FSA* will not investigate a complaint under the *complaints scheme* which it reasonably considers amounts to no more than dissatisfaction with the *FSA's* general policies or with the exercise of, or failure to exercise, a discretion where no unreasonable, unprofessional or other misconduct is alleged.

I would also add that although you state, in your opinion, the FSA's decision to use a regime of 'light touch regulation' has clearly failed as insufficient pressure was applied to Firm A' management in light of the concerns the FSA had about the level of risk it was taking and its risk management activities, you have again provided insufficient, if any, evidence to show that the decisions the FSA took at the time were either incorrect or unreasonable. I am sorry but without such evidence paragraph 1.4.2A of COAF means that I am unable to consider this particular element (element six) of your complaint.

Similarly, although you feel that the FSA should publish full details of the concerns it had with Firm A, the FSA is not able to provide any further details to those already disclosed. I appreciate that you feel that it should and I can understand why you have approached me with a view to instructing the FSA to do this. Unfortunately, I, like the FSA, cannot comment further on the matter. This is not because I wish to be unhelpful, but it is because Section 348 of the Act limits the FSA (and me) from informing you of the full details of the concerns the FSA had with Firm A and its risk management strategy. You can view the appropriate sections of the Act, explaining the restrictions on the disclosure of information, on the internet at http://www.opsi.gov.uk/acts/acts2000/ukpga_20000008_en_1.

In summary, Section 348 of the Act imposes upon the FSA, as the regulator, a ruling of confidentiality in the context of disclosing its response or position when acting in the discharge of its function as the relevant regulator. This means that, other than in limited circumstances, the FSA is unable to disclose any information about what action it did or did not take against a firm or individual (and the reasons for that decision). While I am able to delve more deeply into such matters in my role as Complaints Commissioner to enable me to be satisfied as to the propriety of what the FSA has done, which I have done, I am limited, in most cases, as to the further disclosure of the details that I am informed about. In this instance, I do not believe that the circumstances are exceptional and as a result I do not believe that I am able comment further on the FSA's specific concerns or the discussions it was having with Firm A.

I would however stress that Section 348 of the Act applies purely to the information the FSA can release about a firm and does not apply to firms withholding information from the FSA. The FSA imposes a requirement on firms to be honest and open with it and as such any information the FSA would expect it provide to it (such as an adverse change to its business) must be provided to the FSA without delay and cannot be withheld.

In your response to my Preliminary Decision, you asked me to comment specifically on a number of issues surrounding the capital and liquidity position of Firm A prior to its rights issue. As I have explained above I can confirm that the FSA has provided me with evidence to show that this was considered but other than confirming this, Section 348 of the Act, prevents me from commenting further on this issue. I should add that Parliament put in place that section of the Act which naturally I must adhere to.

You also highlighted that the recent White Paper entitled Reforming Financial Markets (which includes banking reforms) confirms that there were failings by the FSA, the Bank of England and the Treasury (the Tripartite Authority) in relation to the risks taken by UK banks, including Firm A, and therefore you feel that the FSA has failed to regulate banks appropriately. Although I accept that the White Paper does make a number of recommendations on how the banks should be regulated in the future, it does not prove that the FSA acted inappropriately or that the decisions it took, within the regulatory frame work that is in place were incorrect or unreasonable based on the information it had at the time.

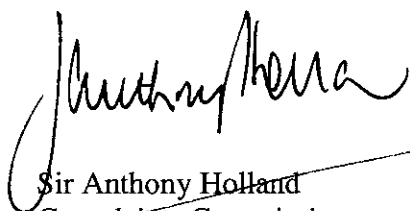
Conclusion

I am sorry, but from the papers presented to me I am unable to find any evidence to show that the FSA acted either incorrectly or unreasonably when considering Firm A' request to undertake a rights issue to existing shareholders. I have also not seen any evidence to suggest that the FSA (or Firm A) either withheld or failed to release information about Firm A financial position prior to the prospectus being authorised by the FSA or between the prospectus being issued and the rights issue taking place.

Similarly, you have not provide sufficient, if any, evidence to show that the FSA failed adequately to consider the allegations Mr X made in late 2004. You have not provided sufficient, if any, evidence to show that the FSA either failed to act or take a reasonable course of action upon the concerns it had prior to Mr X's allegation and which it continued to have after these allegations. I am sorry but I am therefore unable to alter the decision previously made by the FSA. I appreciate that you will be disappointed with my findings, but hope that you will understand why I have arrived at this decision.

I would add one final comment. From your letter to my office it appears that you decided to purchase a large number of Firm A shares (those allocated to you under the rights issue) after you were given a reassurance by a member of Firm A staff. However, the purchase of shares is by its nature a transaction which carries a degree of risk and one which cannot be removed regardless of the protection placed upon the market. As the reassurance was given to you by a member of Firm A' staff, rather than by a member of FSA staff, then the overall decision to buy the shares, irrespective of the FSA's supervision of Firm A' risk model, was yours and was not, in my opinion, influenced at all by the actions of the FSA. If you feel that reassurance you were given, and which you claim convinced you to purchase the shares was based on false or incorrect information, then your complaint is with the Firm A rather than with the FSA and should therefore be directed to it.

Yours sincerely,



Sir Anthony Holland
Complaints Commissioner

Appendix 1

PART II RISK FACTORS

All the information set out in this Prospectus should be carefully considered and, in particular, those risks described below. If any of the following risks actually materialise, HBOS's business, financial condition, prospects and share price could be materially and adversely affected to the detriment of HBOS and its Shareholders and you may lose all or part of your investment. All risks of which the Directors are aware at the date of this Prospectus and which they consider material are set out in this Part II; however, further risks which are not presently known to the Directors, or that the Directors currently deem immaterial, may also have a material effect on HBOS's business, financial condition and operating results. Investors and prospective investors should consider carefully whether an investment in the Company is suitable for them in light of the information in this Prospectus and the financial resources available to them.

1. Risks Relating to the Group and its Business

The Group's business is affected by general economic conditions in the markets in which it operates and in particular in the UK

The Group's business is affected by economic conditions in the UK, where the majority of the Group's earnings are generated, as well as in the other geographical areas in which it operates. Business and consumer confidence, employment trends, the state of the economy, including the state of the UK housing market, the commercial real estate sector, equity markets, inflation, the availability and cost of credit, the liquidity of the global financial markets and market interest rates at the time may impact the Group's earnings. In particular, significantly higher UK unemployment, reduced corporate profitability, increased corporate insolvency rates and/or increased interest rates may reduce borrowers' ability to repay loans and may cause prices of residential or commercial real estate or other asset prices to fall further, thereby reducing the collateral value on many of the Group's loans and increasing impairment losses. An economic downturn, lower transaction volumes in key markets, such as UK housing, or difficult market conditions may also reduce demand for and persistency of many of the Group's products, resulting in lower volumes and profitability. Results from the Group's investment and trading portfolios could also be adversely affected by a general economic downturn or market volatility leading to lower realisations or write-downs of investments. The profitability of the Group's insurance business could be affected by increased claims from factors such as increased unemployment or adverse weather conditions. The Group is also exposed to adverse economic conditions in other jurisdictions where it has material operations. The global and UK financial markets and credit conditions have been affected by financial dislocations which are impacting the wider economy. While the Group believes it has developed a diversified business model to operate in many different markets and cycles, adverse economic conditions in these markets could have a material adverse effect on the Group's business, financial condition and results of operations.

The financial performance of the Group is affected by borrower and counterparty credit quality in the markets in which it operates, in particular in the UK

Risks arising from changes in credit quality and the recoverability of loans and amounts due from counterparties are inherent in a wide range of HBOS's businesses. Adverse changes in the credit quality of HBOS's borrowers and counterparties or falls in collateral values could affect the recoverability and value of HBOS's assets and require an increase in HBOS's impairment provision for bad and doubtful debts and other provisions and in turn adversely affect the financial performance of the Group. In particular, higher UK unemployment, reduced corporate profitability and/or increased corporate insolvencies and/or increased interest rates may reduce borrowers' ability to repay loans.

HBOS provides secured and unsecured loans to borrowers, principally in the UK. UK house prices have declined in recent months, reflecting economic uncertainty, reduced affordability and lower availability of credit from lenders. Economic or other factors may lead to further contraction in the mortgage market and further falls in house prices. Many borrowers in the UK borrow on short-term fixed or discounted floating rates and when such rates expire the continued reduced supply of mortgages together with the potential for higher mortgage rates may lead to some borrowers facing significantly higher mortgage interest payments, which could result in higher delinquency rates. The Group provides mortgages to homeowners and also to buy-to-let investors where an excess supply of rental property or falls in rental demand could also impact the borrowers' income and ability to service the loans. These factors and more difficult economic conditions such as increased unemployment could lead to an increase in impairment losses.

HBOS has exposures to a range of corporate customers in different sectors, including investors in and developers of commercial real estate and residential property where exposures arise from loans, joint ventures and other investments. Commercial real estate prices have shown declines over the last year and developers of residential property are facing challenging market conditions including lower prices and volumes. Whilst the Group assesses counterparties principally on the strength of the underlying businesses rather than the value of collateral, a failure of these borrowers or ventures to operate through the economic cycle combined with falls in collateral values could adversely impact the Group's ability to recover on these loans or lead to write-downs of investments in this sector.

The Group uses a range of policies and techniques to mitigate credit risk, including credit scoring, behavioural scoring and affordability measures for retail portfolios, credit assessments for corporate portfolios and credit risk policies. The Group also imposes product, sector and country limits to avoid excessive concentrations of risk. However, these measures will only mitigate, and not avoid, credit risk and the assumptions on which they are based may prove inadequate or inaccurate in light of economic changes or otherwise, in which case credit risk could have a material adverse impact on the Group's financial condition and results of operations.

Changes in interest rates, foreign exchange rates and commodity and equity prices and other market risks affect the Group's business and financial results

Market risk is defined as the potential loss in value or earnings of the Group arising from changes in external market factors such as interest rates, foreign exchange rates, commodity and equity prices and the potential for customers to act in a manner which is inconsistent with business, pricing and hedging assumptions. Changes in interest rate levels, yield curves and spreads may affect the interest rate margin realised between lending and borrowing costs. Since August 2007, there has been a period of high and volatile interbank lending rates, which has exacerbated this issue. In order to remain competitive, or as a result of rates being fixed in existing loan commitments or facilities the Group may be unable to change the interest rates that it charges or pays to its customers in response to changes in interest rates that affect its wholesale borrowing or may have to increase the rates it pays to wholesale and retail customers.

Changes in currency rates affect the value of assets and liabilities denominated in foreign currencies and may affect earnings reported by HBOS. In the Group's international businesses, earnings and net assets are denominated in local currency which will fluctuate with exchange rates in Sterling terms.

Market risk within the insurance and investment businesses arises in a number of ways and depending upon the product: some risks are borne directly by the customer and some by the Group's insurance and investment businesses. The performance of the investment markets (equities, property and fixed income) has a direct impact on the Group's financial position and performance and can affect investor confidence resulting in lower sales or reduced persistency.

Market and other risks – principally interest rate, inflation, equity and mortality – also arise from the Group's defined benefit pensions obligations.

The Group's treasury trading portfolio also incurs market risk. Marketable assets held in trading and banking books, give rise to market risk as a result of movements in credit spreads. This risk, and its possible impact, is described under "HBOS's future earnings could be affected by declines in financial asset valuations resulting from deterioration in market conditions" below.

Whilst HBOS has implemented risk management methods, including hedging and portfolio diversification, to mitigate and control these and other market risks to which it is exposed, it is difficult to predict with accuracy changes in economic or market conditions, and such changes could have a material adverse effect on HBOS's business, financial position and results of operations.

Funding and liquidity risks are inherent in the Group's operations

Liquidity risk is the risk that the Group does not have sufficient financial resources to meet its obligations when they fall due or will have to do so at excessive cost. This risk can arise from mismatches in the timing of cashflows relating to assets, liabilities and off-balance sheet instruments. In order to ensure that the Group continues to meet its funding obligations and to maintain or grow its business generally, it relies on customer savings and transmission balances, as well as ongoing access to the wholesale lending markets. The ability of the Group to access wholesale and retail funding sources on favourable economic terms is dependent on a variety of factors, including a number of factors outside of its control, such as general market conditions and confidence in the UK banking system. In wholesale markets, the Group typically looks to achieve a geographically diverse investor base and product set of an appropriate maturity profile to ensure it is not overly exposed to short-term market dislocation. In the current market conditions, global investor appetite in the medium and long term markets, including securitisations, remains greatly reduced and the cost of wholesale funds remains high by historical comparison. However, HBOS continues to fund effectively and holds a significant liquidity portfolio of assets that are available to generate funds through either outright sale or sale and repurchase arrangements with other market participants, depositories or central banks. In times of systemic market liquidity stress, or in the event of damage to market confidence in HBOS, the Group's ability to access sources of funding and liquidity could be constrained. A worsening of the current systemic market liquidity stress may further constrain HBOS's ability to access sources of funding and liquidity. No statement contained in this risk factor should be taken as qualifying the statements made as to sufficiency of working capital in paragraph 20 of Part XVIII ("Additional Information") of this document.

The Group's insurance businesses are subject to inherent risk involving claims

Insurance risk is the risk that claims arise (in both life assurance and general insurance contracts) from events outside HBOS's control over and above those which have been assumed in pricing and reserving.

Catastrophic weather conditions, particularly storms and flooding, and adverse changes in economic conditions, including increased unemployment, could lead to increased general insurance claims. While HBOS reinsures some of the risks it has assumed, especially in order to mitigate the impact of extreme weather events in the Household book, increased claims would adversely affect the profitability of current and future insurance products and services.

Demographic and medical developments, which give rise to changes in mortality and morbidity, could have an adverse impact on the value of the life assurance portfolio.

The Group's investment businesses are subject to inherent risks including investment returns and actuarial assumptions

Changes in the general economic climate, conditions of financial markets (equities, property or fixed interest assets) and competitor actions can impact the level of demand for HBOS's investment products, their persistency, the value of assets under management and the profit of the businesses.

Under IFRS, UK banks account for long term assurance contracts, being insurance contracts and investment contracts with discretionary participation features, on an Embedded Value ("EV") basis. Applying the EV basis results in the earlier recognition of profit on new business, but subsequently a lower contribution from existing business, when compared to the recognition of profits on investment contracts under IAS 39 (Financial Instruments: Recognition and Measurement). Differences between actual and expected experience on existing business may have a significant impact on an EV basis, as changes in experience can result in significant adjustments to modelled future cashflows. EV is calculated based on best estimate assumptions made by management, including value of investments under management, mortality experience and persistency. If these assumptions prove wrong, the EV of the insurance contracts could be materially reduced, which in turn could have a material adverse effect on the Group's business, financial position and results of operations.

The insurance and investment business includes the Clerical Medical With-Profits Fund, which comprises 18% of the Group's long term insurance and investment contract liabilities. The fund does take some investment risk with the aim of enhancing policyholder returns, but is managed with the intention that the fund is able to support its payouts from its own assets. However, in exceptional circumstances, and even after management action, this might not be possible which may adversely impact HBOS's financial position.

Operational and reputational risks are inherent in the Group's businesses

Operational risk is the risk of opportunities foregone, reputational damage or financial losses resulting from inadequacies or failures in internal processes, people or systems (including IT systems), or from external events. HBOS's businesses are dependent on the ability to process a very large number of transactions efficiently and accurately. Operational risk and losses can result from fraud (including inaccurate information being provided by counterparties or customers on which the Group relies), human error, failure to document transactions properly or to obtain proper internal authorisation, failure of third parties to comply with material agreements, failure to comply with legislative or regulatory requirements and conduct of business rules, equipment failures, information loss, natural disasters or the failure of external systems, for example, those of HBOS's suppliers or counterparties.

Damage to HBOS's reputation including to consumer confidence could have a significant adverse impact on the Group's business. Although HBOS has implemented risk controls and loss mitigation actions, and substantial resources are devoted to developing efficient procedures and to staff training, there can be no assurance that such procedures will be effective in controlling each of the operational risks or that damage to HBOS's reputation will not arise, which could have a material adverse effect on the Group's business, financial position and results of operations.

This risk factor should not be taken as implying that either HBOS or any other member of the Group will be unable to comply with their obligations as companies with securities admitted to the Official List or as supervised firms regulated by the FSA.

HBOS's borrowing costs and its access to the capital markets depend significantly on its credit ratings

The long-term credit ratings for HBOS and Bank of Scotland are, respectively, AA- and AA with a stable outlook from S&P's rating service, Aa2 and Aa1 with a negative outlook from Moody's rating service, AA+ and AA+ with a negative outlook from Fitch Ratings and AA (high) with a negative outlook from DBRS. Reduction in the long-term credit ratings of HBOS or Bank of Scotland may increase its borrowing costs, limit its access to the capital markets and trigger additional collateral requirements in derivative contracts and other secured funding arrangements. Therefore, a reduction in credit ratings could adversely affect the Group's access to liquidity and competitive position and, hence, have a material adverse effect on the Group's business, financial position and results of operations.

HBOS is subject to capital requirements that could limit its operations

HBOS and certain other members of the Group are subject to capital adequacy guidelines adopted by the FSA for a bank or a bank holding company, which provide for a minimum ratio of total capital to risk-adjusted assets both on a consolidated basis and on a solo-consolidated basis expressed as a percentage.

The risk-adjusted capital guidelines (the "Basel Accord") promulgated by the Basel Committee on Banking Supervision (the "Basel Committee"), which form the basis for the FSA's capital adequacy guidelines, have been revised and implemented in the UK with effect from 1 January 2007 ("Basel II"). The principal changes effected by the revised guidelines include a range of options to determine risk-weighting. In this regard, HBOS has adopted the Advanced Internal Ratings Based Approach (for Credit Risk) and the Advanced Measurement Approach (for Operational Risk) with effect from 1 January 2008. This follows a year of parallel running of these approaches. Certain portfolios remain on the standardised approach with agreement with the FSA of a timetable for further roll out of credit risk models over the next two years. Under Basel II, capital requirements are inherently more volatile than under previous regimes and will increase if economic conditions or default trends worsen.

The Group's banking businesses outside the UK are subject to the capital adequacy regimes of those jurisdictions, some of which will implement Basel II on a longer time frame.

The Group's life assurance and general insurance businesses in the UK are also subject to the capital requirements prescribed by the FSA, and the Group's life and general insurance companies outside the UK are subject to local regulatory capital requirements. In July 2007, the European Commission published a draft proposal for primary legislation to define broad "framework" principles for Solvency II, a fundamental review of the capital adequacy regime for the European insurance industry. Solvency II aims to establish a revised set of EU-wide capital requirements where the required regulatory capital will be dependent upon the risk profile of the entities, together with risk management standards, that will replace the current Solvency I requirements. At this early stage of development, it is not possible to predict the ultimate impact of this proposed regime on the Group's capital. However, the final regime could significantly impact the capital the Group's life assurance and general insurance businesses are required to hold.

HBOS's failure to maintain adequate capital ratios may result in administrative actions or sanctions against it which may have a material adverse impact on HBOS's business, financial position and results of operations.

The values of certain securities held by the Group are recorded at fair value as determined by using financial models incorporating assumptions, judgements and estimates that are inherently uncertain and which may change over time

Under IFRS as adopted by the EU, HBOS recognises at fair value: (i) financial instruments classified as "held-for-trading" or "designated as at fair value through profit or loss", (ii) financial assets classified as "available-for-sale" and (iii) derivatives. The fair value of investment securities trading in active markets is based on market prices or broker/dealer valuations. Where quoted prices on instruments are not readily and regularly available from a recognised broker, dealer or pricing service, or available prices do not represent regular transactions in the market, the fair value is estimated. These estimates are referenced based on quoted market prices for securities with similar credit, maturity and yield characteristics or similar valuation models. In certain circumstances, the data for individual financial instruments or classes of financial instrument utilised by such valuation models may not be available or may become unavailable due to changes in market conditions, as has recently been the case. In such circumstances, HBOS's internal valuation models require it to make assumptions, judgements and estimates in order to establish fair value. In common with other financial institutions, these internal valuation models are complex, and the assumptions, judgements and estimates HBOS is required to make often relate to matters that are inherently uncertain. Such assumptions, judgements and estimates are updated to reflect changing trends and market conditions. Any change in the fair values of the financial instruments could have a material adverse effect on HBOS's business, financial position and results of operations.

HBOS's future earnings could be affected by declines in financial asset valuations resulting from deterioration in market conditions

Financial markets are sometimes subject to significant stress conditions where steep falls in perceived or actual asset values are accompanied by a severe reduction in market liquidity, as exemplified by recent events.

The Group's Treasury division holds a portfolio of debt securities. Included within this portfolio HBOS has credit exposure to monolines both through wrapped bonds and purchased credit default swap protection. At 31 December 2007 and subsequently, the Group made negative fair value adjustments relating primarily to its holdings of asset backed securities and floating rate notes in its trading books, and to its available for sale reserves in respect of its holding of debt securities in its banking book (although the banking book adjustments have no impact on reported profits or regulatory capital strength unless there is a credit impairment or assets are sold at below cost).

Whilst HBOS believes it has adopted a prudent basis for the valuation of its treasury assets, the fair value of these assets could fall further than currently estimated and therefore result in additional negative adjustments. In addition, default by a monoline insurer in respect of wrapped bonds or credit default swaps held by the Group could lead to further deterioration in asset values. Valuations in future periods, reflecting then-prevailing market conditions, may result in further negative changes in the fair values of the Group's treasury assets. In addition, the value ultimately realised by HBOS may be different from the

current or estimated fair value and changing economic circumstances may result in some credit impairment. Any of these factors could require HBOS to recognise further fair value adjustments or realise impairment charges, any of which may have a material adverse effect on its capital position, financial condition and results of operations.

Each of the Group's businesses is subject to substantial regulation and oversight. Any significant regulatory developments could have an effect on how the Group conducts its business and on its results of operations.

The Group is subject to laws, regulations, administrative actions and policies in each location in which it operates, all of which are subject to change. The FSA is the main regulator for HBOS, although the Group's international businesses in the United States, Australia and Ireland are subject to direct scrutiny from the Board of Governors of the Federal Reserve System and the Comptroller of the Currency, the Australian Prudential Regulation Authority and the Irish Financial Regulator respectively. Changes in supervision and regulation, in particular in the UK, could materially affect the Group's businesses, the products and services offered or the value of its assets. Although the Group works closely with its regulators and continually monitors developments, future changes in regulation, fiscal or other policies can be unpredictable and are beyond the control of the Group. Areas where changes could have an adverse impact include, but are not limited to:

- the monetary, interest rate and other policies of central banks and regulatory authorities;
- general changes in government or regulatory policy or changes in regulatory regimes that may significantly influence investor decisions in particular markets in which HBOS operates, may change the structure of those markets and the products offered or may increase the costs of doing business in those markets;
- other general changes in the regulatory requirements, such as prudential rules relating to the capital adequacy or liquidity frameworks;
- changes to the arrangements for funding depositor or investor protection schemes and providing compensation in the event of a failure of another regulated firm;
- external bodies applying or interpreting standards or laws differently to those applied by the Group historically;
- changes in competition and pricing environments;
- further developments in the financial reporting environment;
- expropriation, nationalisation, confiscation of assets and changes in legislation relating to foreign ownership; and
- other unfavourable political, military or diplomatic developments producing social instability or legal uncertainty which, in turn, may affect demand for HBOS's products and services.

Further changes to the regulatory requirements applicable to the Group, in particular in the UK, whether resulting from recent events in the credit markets or otherwise, could have a material adverse effect on its business, the products and services it offers, its financial position and results of operations.

HBOS is subject to litigation and regulatory investigations which may impact its business

HBOS and its subsidiaries operate in a legal and regulatory environment that exposes them to potentially significant litigation and regulatory risks. As a result, the Group is and may in the future be involved in various disputes and legal proceedings in the UK and the other jurisdictions in which it operates, including litigation and regulatory investigations. Such cases are subject to many uncertainties, and their outcome is often difficult to predict, particularly in the earlier stages of a case or investigation. Currently, the Group is responding to regulatory inquiries and investigations and is involved in litigation arising from its operations. Regulatory intervention is an ongoing feature of UK retail banking and changes could affect the profitability of the Group's Retail business. For example, HBOS is one of eight banks involved in a test case to resolve legal uncertainties concerning the fairness and lawfulness of unarranged overdraft charges. In addition, the Competition Commission investigation of the payment protection insurance market may ultimately impact the profitability of HBOS and across the industry more generally. For details about certain litigation and regulatory investigations in which HBOS is involved, see paragraphs 18 and 19 of Part XVIII ("Additional Information").

Adverse regulatory action against the Group or adverse judgements in litigation to which the Group is a party could result in restrictions or limitations on the Group's operations or result in a material adverse effect on the Group's reputation, business and results of operations.

Future earnings growth and shareholder value creation depend on the Group's strategic decisions

Significant resources are devoted to the formulation and implementation of the Group's strategy. If elements of the strategy do not deliver as intended, either as a result of internal factors such as poor implementation associated with strategic change, or external factors, such as competitor actions, the Group's earnings may grow more slowly or decline.

The Group's financial performance is subject to substantial competitive pressures

There is substantial competition for the types of banking and other products and services that the Group provides in the regions in which it conducts its business. The intensity of this competition is affected by competitor behaviour, consumer demand, technological changes, the impact of consolidation, regulatory actions and other factors.

The Group's financial performance may be adversely impacted by competition, including declining lending margins or competition for savings driving up funding costs which cannot be recovered from borrowers. Customer attrition, as well as adverse persistency, in the Group's Investment business and General Insurance business is a risk to current and future earnings. The Group's growth plans are predicated on attracting customers from competitors and retaining and broadening existing customer relationships. If HBOS is not successful in attracting new customer relationships or retaining and broadening existing customer relationships, the Group will not be able to deliver the level of growth that it expects. The success of the Group's strategy will also be affected by the competitor reaction of both incumbent banks and new entrants to its markets.

If the Group is unable to provide attractive product and service offerings that are competitive and profitable, it may lose market share, incur losses on some or all of its activities or fail to attract new and retain existing deposits, which could have a material adverse effect on its business, financial position and results of operations.

HBOS may be adversely affected by changes in taxation legislation

HBOS's tax charge is based on current legislation in the countries in which the Group operates. Taxation legislation may be subject to future changes which could have a material adverse effect on HBOS's results of operation and financial condition.

HBOS could fail to attract or retain senior management or other key employees

HBOS's success depends on the ability and experience of its senior management. The loss of the services of certain key employees, particularly to competitors, could have a material adverse effect on the Group's revenue, profit and financial condition. In addition, as the Group's business develops, both in the UK and in other jurisdictions, the Group's future success will depend on its ability to attract and retain highly skilled and qualified personnel, which cannot be guaranteed. The failure to attract or retain a sufficient number of appropriate personnel could significantly impede HBOS's financial plans, growth and other objectives and have a material adverse effect on the Group's business, financial position and results of operations.

2. Risks Relating to the Rights Issue and the New Shares

HBOS's share price will fluctuate

The market price of the New Shares (including the Nil Paid Rights and the Fully Paid Rights) and/or the Shares could be subject to significant fluctuations due to a change in sentiment in the market regarding the New Shares (including the Nil Paid Rights and the Fully Paid Rights) and/or the Shares (or securities similar to them). Such fluctuations may depend on the market's perception of the likelihood of completion of the Rights Issue, and/or in response to various facts or events, including any regulatory changes affecting the Group's operations, variations in the Group's own operating results, business developments of the Group or those of its competitors or economic changes. Stock markets have, from time to time, experienced significant price and volume fluctuations that have affected the market prices for securities and which may be unrelated to the Group's operating performance or prospects. Furthermore, the Group's operating results and prospects from time to time may be below the expectations of market analysts and investors. Any of these events could result in a decline in the market price of the New Shares (including the Nil Paid Rights and the Fully Paid Rights) and/or the Shares.

An active trading market in the Nil Paid Rights may not develop

An active trading market in the Nil Paid Rights may not develop on the London Stock Exchange during the trading period. In addition, because the trading price of the Nil Paid Rights depends on the trading price of the Shares, the Nil Paid Rights price may be volatile and subject to the same risks as noted elsewhere herein. This may impact on investors' ability to sell Nil Paid Rights should they wish to do so.

HBOS's ability to continue to pay dividends will depend on the level of profits and cash flows generated by the Group

Under UK company law, a company can only pay cash dividends to the extent that it has distributable reserves and cash available for this purpose. As a holding company, HBOS's ability to pay dividends in the future is affected by a number of factors, principally its ability to receive sufficient dividends from subsidiaries. The payment of dividends to HBOS by its subsidiaries is, in turn, subject to restrictions, including certain regulatory requirements and the existence of sufficient distributable reserves and cash in HBOS's subsidiaries.

The ability of these subsidiaries to pay dividends and HBOS's ability to receive distributions from its investments in other entities are subject to applicable local laws and regulatory requirements and other restrictions, including, but not limited to, applicable tax laws and covenants in some of HBOS's debt

facilities. These laws and restrictions could limit the payment of dividends and distributions to HBOS by its subsidiaries, which could in future restrict HBOS's ability to fund other operations or to pay a dividend to holders of the Existing Shares or the New Shares.

Shareholders who do not subscribe in full for their entitlement to New Shares in the Rights Issue will experience dilution in their ownership of HBOS

If Shareholders do not subscribe in full for their entitlement to New Shares under the Rights Issue their proportionate ownership and voting interests in HBOS will be reduced and the percentage that their shares will represent of the total share capital of the Company will be reduced accordingly. Even if a Shareholder elects to sell his Nil Paid Rights, or such Nil Paid Rights are sold on his behalf, the consideration he receives may not be sufficient to compensate him fully for the dilution of his percentage ownership of the Company's share capital that may be caused as a result of the Rights Issue.

If the Company is unable to complete the Rights Issue, it may need to consider alternative methods of increasing its core Tier 1 and Tier 1 capital ratios

The purpose of the Rights Issue is to allow the Company to strengthen its capital position against the backdrop of current market volatility. If the Company is unable to complete the Rights Issue, the Board may need to consider alternative methods for achieving its stated target capital ratios, which could include a reduction in dividends, a reduction in the rate of growth of risk weighted assets, disposal of certain businesses or increased issuance of Tier 1 securities. If such measures were unsuccessful, there is a risk that HBOS would be unable to achieve satisfactory capital ratios and therefore the benefits of such capital ratios would not be obtained.

3. Additional risks for Overseas Shareholders

The ability of Overseas Shareholders to bring actions or enforce judgements against HBOS or the Directors may be limited

The ability of an Overseas Shareholder to bring an action against HBOS may be limited under law. HBOS is a public limited company incorporated in Scotland. The rights of holders of Shares are governed by Scots law and by HBOS's Memorandum and the Articles. These rights differ from the rights of shareholders in typical US corporations and some other non-UK corporations. In particular, both Scots law and English law significantly limit the circumstances under which shareholders of companies may bring derivative actions. Under both Scots and English law generally, only a company can be the proper pursuer or claimant in proceedings in respect of wrongful acts committed against it. In addition, it may be difficult for an Overseas Shareholder to prevail in a claim against HBOS under, or to enforce liabilities predicated upon, non-UK securities laws.

An Overseas Shareholder may not be able to enforce a judgement against some or all of the Directors and executive officers. The vast majority of the Directors and executive officers are residents of the UK and currently only one is a resident of the United States. Consequently, it may not be possible for an Overseas Shareholder to effect service of process upon the Directors and executive officers within the Overseas Shareholder's country of residence or to enforce against the Directors and executive officers judgements of courts of the Overseas Shareholder's country of residence based on civil liabilities under that country's securities laws. There can be no assurance that an Overseas Shareholder will be able to enforce any judgements in civil and commercial matters or any judgements under the securities laws of countries other than the UK against the Directors or executive officers who are residents of the UK or countries other than those in which judgement is made. In addition, English or other courts may not impose civil liability on the Directors or executive officers in any original action based solely on the foreign securities laws brought against HBOS or the Directors in a court of competent jurisdiction in England or other countries.



FSA statement re: HBOS

11 February 2009

Further to our earlier statement, the Financial Services Authority (FSA) has issued the following fuller account of the issues relating to the risk function at HBOS, raised at the Treasury Select Committee on 10 February 2009.

1. Having examined carefully the files relating to this issue, the FSA can confirm that specific allegations made by Paul Moore in December 2004 regarding the regulatory risk function at HBOS were fully investigated by KPMG and the FSA, which concluded that the changes made by HBOS were appropriate. This statement gives an account of the actions taken by the FSA in relation to concerns expressed in 2004 by Mr Moore, former head of Group Regulatory Risk at HBOS. It is focused on these specific concerns rather than providing a complete description of the regulatory relationship with HBOS.

Risk assessment

2. As background to the specific set of allegations made by Mr Moore, we set out below relevant developments in relation to the HBOS risk framework:

- the FSA conducted a full risk assessment of HBOS (known as an ARROW assessment) in late 2002 which identified a need to strengthen the control infrastructure within the group;
- we then decided to commission a "skilled persons report" from PWC on the HBOS risk management framework, using formal information gathering powers under section 166 of the Financial Services and Markets Act 2000: their extensive report revealed a need for improvements in the HBOS risk management environment;
- the FSA then conducted a further full risk assessment of the HBOS group to cover all of the group's business, formally recording its assessment in December 2004, the assessment was that the risk profile of the group had improved and that the group had made good progress in addressing the risks highlighted in February 2004, but that the group risk functions still needed to enhance their ability to influence the business, which we saw as a key challenge.

Changes at HBOS

3. Other key events took place in 2004:

- following the departure of the Chief Financial Officer, who had been responsible at Board level for regulatory risk, and as part of a wider restructuring, HBOS decided to upgrade the risk function by appointing a new group risk director as the senior executive responsible for regulatory risk in the group;
- following that appointment, the then head of group regulatory risk, Paul Moore, was informed on 8 November that he would leave as part of this restructuring; he subsequently approached FSA to express concerns about HBOS and in particular about the suitability of the new appointee as the group risk director;
- in his view, the new group risk director was not 'fit and proper' to be approved by the FSA to hold that post, by reason of lack of integrity, lack of experience in risk management, and of general attitude and approach;
- he also made other allegations about HBOS's overall risk framework.

Action taken by the FSA

4. Urgent action was taken to follow up these specific allegations:

- following consultation with the FSA, the HBOS Group Audit Committee commissioned an external review on the fitness issues from its auditors KPMG: the FSA satisfied itself about the skill and independence of the individuals selected to conduct the report for KPMG and about the scope of the report;
- KPMG undertook around 80 hours of interviews and meetings with 28 individuals including the HBOS CEO, CFO, and then Head of Retail, as well as the former head of regulatory risk himself;
- the FSA suspended its decision on whether or not to approve the appointment to the new role, pending receipt of the results of the KPMG investigation;
- the FSA approved that individual only when it had received those results, which indicated that KPMG 'did not believe that the evidence reviewed suggested that the candidate was not fit and proper', that 'the process for the identification and assessment of candidates for the GRD position appeared appropriate', and that 'the structure and reporting lines of Group Regulatory Risk are appropriate';
- the KPMG report also indicated that there was no evidence in the report that Mr Moore was dismissed due to being excessively robust in the discharge of his functions. (It should be understood that the KPMG report concerned the allegation that the new director was not fit and proper rather than the more general issue of HBOS' risk control framework identified in the skilled persons report. The KPMG report did not extend to these issues.)

- The FSA also followed up Mr Moore's concerns by meeting him independently and separately discussed the KPMG report directly with KPMG.

Subsequent relevant events

5. The FSA continued to pursue concerns about the risk management framework. As a consequence, we wrote to HBOS again on 29 June 2006 with a further interim ARROW risk assessment. In that letter we made clear:

- that whilst the group had made progress, there were still control issues. We made clear that we would closely track progress in this area;
- the growth strategy of the group posed risks to the whole group and that these risks must be managed and mitigated.

Conclusion

6. In conclusion, the FSA confirms that the allegations made by Mr Moore were taken seriously, and were properly and professionally investigated. It should also be noted that the FSA's concerns about HBOS' risk management framework considerably pre-dated the allegations by Mr Moore.

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