FINANCIAL CONDUCT AUTHORITY

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FINAL NOTICE

To:	**Lloyds Bank PLC, Bank of Scotland plc, and The Mortgage Business Plc**
Reference Numbers:	**119278, 169628 and 304154**
Addresses:	**25 Gresham Street, London, EC2V 7HN** **The Mound, Edinburgh, Midlothian, EH1 1YZ** **Trinity Road, Halifax, West Yorkshire, HX1 2RG**
Date:	**11 June 2020**

1. ACTION

1.1. For the reasons given in this Final Notice, the Authority hereby imposes on Lloyds Bank PLC, Bank of Scotland plc and The Mortgage Business Plc (together "the Banks") a financial penalty of £64,046,800 pursuant to section 206 of the Act.

1.2. The Banks agreed to resolve all issues of fact and liability and qualified for a 30% discount under the Authority's executive settlement procedures. Were it not for this discount, the Authority would have imposed a financial penalty of £91,495,400 on the Banks.

2. SUMMARY OF REASONS

2.1. Between 7 April 2011 and 21 December 2015 (the "Relevant Period"), the Banks breached Principles 3 and 6 of the Authority's Principles for Businesses in relation to their handling of mortgage customers in payment difficulties or arrears.

2.2. The Banks did not fully rectify failings in their mortgage arrears handling activities during the Relevant Period, despite some of those failings having been identified from as early as April 2011, and despite subsequent identification of issues (in respect of poor customer treatment and inadequate systems and controls) by the Banks' external consultants and the Authority. As a result, some of the failings continued for over four and a half years.

2.3. The Banks put a large number of customers (including those who were likely to be vulnerable) at risk of being treated unfairly.

2.4. It is essential that firms dealing with mortgage customers in financial difficulties, including arrears handling and forbearance activities, effectively engage with the customer so that they can understand the customer's personal circumstances, including whether the individual is a vulnerable customer. Firms should obtain sufficient information to allow them to attempt to agree an appropriate course of action given the customer's personal circumstances. If a firm does not understand the personal circumstances of the customer it may enter into inappropriate or unsustainable arrangements which could result in worsening the customer's financial position and, ultimately, in some cases the repossession of the customer's home that would otherwise have been avoidable. The fair treatment of such customers is therefore of particular importance.

2.5. Throughout the Relevant Period, the Banks' systems and procedures for gathering information resulted in the Banks' call handlers not consistently obtaining adequate information to assess customers' circumstances and affordability, creating a risk that customers were treated unfairly.

2.6. The Banks also used a payment authority matrix (known as the PAM) which set out the minimum percentage of contractual monthly payments which a colleague was authorised to accept as a Payment Arrangement without seeking further authority from a more senior colleague. In practice, the PAM created a risk of inflexibility in approach, with the result that call handlers may fail to negotiate appropriate Payment Arrangements.

2.7. Both these risks were exacerbated through a simplification programme initiated in 2012, as a result of which mortgage arrears handling and unsecured arrears handling were combined resulting in the loss of a large amount of mortgage collections and recoveries expertise. Nearly all of the mortgage arrears call handlers were new-to-role (although many had unsecured call handling experience). Call handlers who were inexperienced in mortgage arrears handling were more likely to rely on the PAM to inform the arrangements they entered into, and less likely to undertake the required investigation of customer circumstances.

2.8. A skilled person appointed to review the Banks' mortgage arrears handling processes looked at a sample of 100 customer files from 2014 – 2015 and identified that there was unfair treatment in 38% of them.

2.9. The Banks' monitoring of their Payment Arrangement practices identified failings in gathering information from customers, but did not appreciate the risk that these would result in unfair treatment, frequently reporting that cases where failures occurred nevertheless were "fair". As a result, management was not sufficiently informed about the nature of the failings that occurred and was unable to identify the risk of unfair treatment. The monitoring systems were also deficient because they considered the fairness of individual customer interactions, rather than considering the customer treatment as a whole.

2.10. In addition, the Banks failed to provide refresher training to call handlers on identifying and dealing with vulnerable customers, and did not adequately review whether call handlers were identifying vulnerable customers. They also had inadequate record-keeping systems and failed to have adequate systems to ensure complaints were properly recognised and acted upon.

2.11. The Authority considers the Banks' failings to be serious for the following reasons:

(1) The breach caused a significant risk of loss to individual consumers who went into arrears during the Relevant Period; and

(2) The breach revealed systemic weaknesses in the Banks' internal systems and controls relating to making Payment Arrangements with customers in mortgage arrears.

2.12. However, the Authority has also taken the following factors into account:

(1) Lloyds Banking Group ("LBG") voluntarily suspended the use of broken Payment Arrangement fees in October 2014 and arrears management fees in respect of secured collections were voluntarily suspended at the end of January 2016; and

(2) In July 2017, LBG implemented a comprehensive consumer redress scheme extending well beyond the Relevant Period and to customers beyond those known to have been treated unfairly. The redress scheme involves refunding arrears management and broken Payment Arrangement fees, unpaid direct debit fees, returned cheque fees and field agent fees and interest on fees for the period from January 2009 to January 2016. The scheme also provides automatic refunds for litigation fees under £750, and (with some limited exceptions) a case-by-case assessment of redress for litigation fees over and above this, for the period from January 2011 to September 2016. It also includes potential payments for distress and inconvenience and consequential losses. In March 2020, LBG estimated that approximately 526,000 customers would receive redress payments totalling approximately £300 million.

2.13. The Authority has also taken into account that the breach was committed inadvertently as well as the nature and extent of cooperation provided by the Banks during the course of the investigation. The Banks acknowledged many of the failings and commissioned an independent third-party to prepare an investigation report which they provided to the Authority, together with interview notes and all underlying materials. In addition, the Banks have taken considerable steps to improve their systems and controls, consistent with the recommendations in the report and made by the Skilled Person appointed by the Authority, and have dedicated considerable resources to making improvements. The Banks continue to work on embedding the changes and making further improvements.

2.14. The Authority hereby imposes on Lloyds Bank PLC, Bank of Scotland plc and The Mortgage Business Plc (together "the Banks") a financial penalty of £64,046,800 pursuant to section 206 of the Act.

3. DEFINITIONS

3.1. The definitions below are used in this Notice:

"1LOD" means the first line of defence in the Banks' "three lines of defence" risk management model – in the context of this notice, this was the Credit Operations Department of the Banks and the BUCF;

"2LOD" means the second line of defence in the Banks' "three lines of defence" risk management model – in the context of this notice, this was MCR and, from November 2011, CCOR;

"3LOD" means the third line of defence in the Banks' "three lines of defence" risk management model – in the context of this notice, this was Group Audit;

"the 2013 Thematic Review" means the Authority's Arrears and Forbearance Management Thematic Review;

"the Act" means the Financial Services and Markets Act 2000;

"the Authority" means the body corporate previously known as the Financial Services Authority and renamed on 1 April 2013 as the Financial Conduct Authority;

"the Banks" means the regulated entities operated by Lloyds Banking Group, that are the subjects of this Notice, namely: Lloyds Bank PLC, Bank of Scotland plc ("BoS") and The Mortgage Business plc;

"the Brands" means the following brands within the Banks' mortgage book: Lloyds, Halifax, Bank of Scotland, Birmingham Midshires, The Mortgage Business, Intelligent Finance, St James' Place and Cheltenham & Gloucester;

"BUCF" means the Business Unit Control Function within the Banks' Operations Division;

"Call Model" means a process flow map to guide call handlers' discussions with mortgage customers in arrears;

"CiFD" means customers in financial difficulty;

"CCOR" means the Banks' Conduct, Compliance and Operational Risk department;

"CMP" means the contractual monthly payment owing under a mortgage contract;

"CPT" means the Banks' Customer Priority Team;

"DISP" means the Dispute Resolution: Complaints section of the Authority's Handbook;

"I&E" means a detailed income and expenditure assessment conducted according to standardised guidelines;

"FAU" means the Banks' Financial Assessment Unit;

"Group Audit" means LBG's internal audit function, which conducts internal audits for LBG, including the Banks;

"HBOS" means Halifax Bank of Scotland plc;

"LBG" or "Lloyds" means Lloyds Banking Group PLC;

"March 2015 Review" means the report dated March 2015 produced by a professional services firm on its quality assurance of a customer file review undertaken by the Banks in late 2014 and early 2015;

"MCR" means Mortgage Credit Risk;

"Management Information" or "MI" means information prepared or collated within the Banks and presented to the senior management of the Banks;

"MCOB" means the Mortgages and Home Finance: Conduct of Business sourcebook in the Financial Services Handbook;

"Outcomes Testing" means reviews carried out by the Banks which assessed the outcome of an interaction between a call handler and a customer in mortgage arrears;

"PAM" means the Payment Authority Matrix, which set out the minimum percentage of CMP which a colleague was able to accept as a Payment Arrangement without further authorisation;

"Payment Arrangement" means an arrangement agreed between the customer and the Banks for the customer to repay their mortgage arrears;

“Principles” means the Principles set out in the Authority’s Principles for Businesses Sourcebook;

“QC” means quality checking;

“RAG” means the “Red” “Amber” “Green” status rating system to track performance;

“RDC” means the Regulatory Decisions Committee of the Authority (see further under Procedural Matters below);

“Relevant Period” means 7 April 2011 to 21 December 2015;

“RLU” means the Banks’ Remote Listening Unit;

“Skilled Person” means the skilled person appointed pursuant to a requirement issued by the Authority under section 166 of the Act in July 2015 to conduct a review of arrears and forbearance handling at the Banks;

“the Tribunal” means the Upper Tribunal (Tax and Chancery Chamber); and

“the Warning Notice” means the warning notice given to the Banks dated 17 December 2019.

4. FACTS AND MATTERS

Background

4.1. Lloyds Bank PLC, Bank of Scotland plc and The Mortgage Business plc (collectively known as “the Banks”) are wholly owned subsidiaries of Lloyds Banking Group plc (“LBG”), which was formed following the merger between HBOS plc (“HBOS”) and Lloyds TSB Bank plc in January 2009. During the Relevant Period, the Banks’ mortgage book comprised several brands. These were Lloyds, Halifax, Bank of Scotland, Birmingham Midshires, The Mortgage Business, Intelligent Finance, St James’ Place and Cheltenham & Gloucester (the “Brands”). Lloyds TSB Bank plc was renamed Lloyds Bank PLC following the divestment of some of its business in September 2013.

4.2. Prior to the merger in 2009, HBOS had been the UK’s largest mortgage lender.

4.3. As a result of the merger, LBG became the largest mortgage provider in the UK and it has held this position within the mortgage market throughout the Relevant Period. As of December 2015, the Banks' regulated mortgage book balance totalled £223 billion, with arrears valued at £285 million. Approximately 367,000 of the Banks' individual customers were in residential mortgage arrears at some point during the Relevant Period.

4.4. LBG faced operational and technical challenges due to the size of the merger, and in 2009 LBG commenced a group-wide project to simplify a number of its processes and to bring the two banks within a single banking framework. This work continued into the Relevant Period.

4.5. LBG's arrears balance during the Relevant Period was larger than that of any other firm in the UK. Different Brands were using different systems, and the back-office teams and operations were located across the country.

Mortgage arrears

4.6. The provision of regulated mortgages and administering regulated mortgages have been regulated activities since 31 October 2004. This includes taking any necessary steps for the purpose of collecting or recovering payments due under the mortgage contract from the borrower. The Authority has made rules imposing requirements on authorised firms in relation to regulated mortgages, which are set out in MCOB. Chapter 13 of MCOB includes specific rules in respect of the information and service provided to customers who have payment difficulties.

4.7. It is essential that firms dealing with mortgage customers in financial difficulties, including arrears handling and forbearance activities, effectively engage with the customer so that they can understand the customer's personal circumstances, including whether the individual is a vulnerable customer. Firms should obtain sufficient information to allow them to attempt to agree an appropriate course of action given the customer's personal circumstances.

4.8. Customers in arrears, or those who are about to enter arrears, who do not enter into repayment agreements in a timely manner can face an accumulation of fees as well as additional arrears and interest on their arrears balance. If the firm does not understand the personal circumstances of the customer it may make inappropriate or unsustainable arrangements which could result in worsening the customer's financial position and, ultimately, in some cases the repossession of the customer's home that may otherwise have been avoidable. The fair treatment of such customers is therefore of particular importance.

The Banks' arrears and forbearance activities history

4.9. In 2008, in the context of the worsening economic conditions, the Authority emphasised to mortgage lenders the importance of treating customers fairly when handling arrears and repossessions. The Authority published a thematic review of mortgage arrears handling in August 2008 which included examples of good and poor practice. The Authority also gave specific feedback to HBOS in July 2008. In November 2008, the Authority sent a "Dear CEO" letter to all mortgage lenders and mortgage administrators reminding them of their responsibilities to ensure the fair treatment of customers.

4.10. Following the Authority's thematic review and "Dear CEO" letter, the Banks took a number of steps aimed at making their arrears handling more customer-centric. These included:

(1) reviewing:
- (a) the policies of the heritage Lloyds TSB business;
- (b) charges;
- (c) letter wording;
- (d) procedures to improve notes of customer calls; and
- (e) the call model;

(2) developing new options for customers in financial difficulties; and

(3) identifying opportunities to improve training, focusing on helping staff undertake a more in-depth analysis of customer circumstances when agreeing an arrangement between the customer and the Banks for the customer to repay their mortgage arrears ("Payment Arrangement").

4.11. In April 2011, the Banks completed an internal review of their mortgage forbearance activities. This review identified problems with the way information was obtained and verified about customer circumstances. From this time, the Banks were or ought to have been aware that these concerns needed to be addressed. In November 2011, the Banks conducted a gap analysis of their compliance with the Authority's guidance on forbearance and impairment provisions and identified actions to comply with examples the Authority gave of good practice.

4.12. During 2011, the Banks commenced a reorganisation of their business structure. Prior to this, the Banks' mortgage business was managed on an "end-to-end" basis. The restructure involved dividing the business into component parts. The Secured Collections and Recoveries team was moved into the Credit Operations Department. Previously, Credit Operations had managed collections and recoveries solely for unsecured lending. Following this move, attempts were made during 2011 and 2012 to align the policies and processes used in secured and unsecured collections and recoveries.

4.13. Further restructuring of the Banks' mortgage arrears handling processes took place as a result of a simplification programme in 2012, through which mortgages and unsecured arrears handling were combined. As part of this, a number of sites that had focused on the recovery of mortgage arrears were closed, with work moving to sites that had previously handled unsecured arrears. This resulted in the loss of a large amount of mortgage collections and recoveries expertise and nearly all of the mortgage arrears call handlers being new-to-role (although many had unsecured call handling experience).

4.14. During the second half of 2013 the Authority conducted visits to LBG in respect of the Halifax brand, as part of its Mortgage Arrears and Forbearance Management Thematic Review (the "2013 Thematic Review").

4.15. The Authority wrote to LBG in January 2014 to provide feedback and raised a number of concerns as a result of the 2013 Thematic Review. These included concerns relating to the inconsistent assessment of individual customer circumstances, inadequate training provided to front-line agents, failures in record keeping, and insufficient oversight arrangements in relation to fair customer outcomes. In respect of oversight, the Authority found that the Banks' quality assurance checks focused on compliance with policies rather than conducting an end-to-end review of the overall customer experience to determine if the outcome was appropriate. The Authority asked LBG to consider the relevance of its findings to other LBG brands in addition to HBOS.

4.16. In March 2014, the Banks responded to the Authority's feedback, providing details of the actions they had already taken or were planning to take in respect of the concerns raised by the Authority. They emphasised that they had made a significant investment in their front-line colleague capability and understanding through over 3,000 hours of enhanced product and negotiation training, the introduction of a Financial Assessment Unit to strengthen understanding of the circumstances of customers experiencing longer term financial difficulty and establishing an approach to third-party suppliers aimed at further strengthening management controls.

4.17. During 2014 and 2015 the Banks took a number of steps to address the concerns raised by the Authority in its 2013 Thematic Review feedback, and in April 2014 established an Executive Steering Group to provide oversight of this activity. On a number of occasions during 2014 and 2015 they informed the Authority that they were on track to implement their planned improvements.

4.18. In late 2014 and early 2015 the Banks conducted a customer file review of mortgage customers in arrears in order to review the implementation of their arrears and forbearance policies and processes. They engaged a professional services firm to undertake a "quality assurance" review of the Banks' work, who produced a report dated March 2015 (the "March 2015 Review"). The Banks' conclusion was that, although there were failings in the way they assessed affordability, and in respect of the communications with customers, there were no instances where customers had been treated unfairly among the files they reviewed from 2014. The Authority disagrees with that conclusion: the failure to assess affordability properly meant that the Banks could not show that Payment Arrangements were set at the right level, and a proper assessment of affordability at an early stage would have better equipped the customer (and the Banks) to make a decision about their options.

4.19. In early 2015, the Banks reviewed 27 further customer files to monitor how well the action taken in response to the Authority's feedback was being implemented. The Authority also reviewed a number of these 27 files. The Authority concluded that the Banks had failed to make adequate progress in addressing the issues raised in its feedback following the 2013 Thematic Review.

4.20. The Banks took steps to review their processes in light of the Authority's publication of a Final Notice against Yorkshire Building Society on 28 October 2014 pertaining to mortgage arrears handling. By the middle of 2015 the Banks had invested significantly in front-line capability and understanding through enhanced product and negotiation training, had completed retrospective case reviews and had implemented the majority of the actions agreed with the Authority. Despite these steps the Banks had not fully rectified the failings in mortgages collections and recoveries resulting in the Authority's decision to appoint a Skilled Person.

4.21. In July 2015, the Authority issued a requirement under section 166 of the Act for a Skilled Person to conduct a review of arrears and forbearance handling at the Banks. The scope of the requirement included a file review assessment to understand if any customers had suffered detriment as a result of the Banks' mortgage arrears processes.

4.22. The Skilled Person reviewed 100 customer files from across some of the Brands offered by the Banks. The non-statistical sample was selected randomly from a list of the Banks' mortgage customers who had fallen into arrears in either 2014 or 2015, and included customers with regulated mortgages at various stages of the arrears handling lifecycle.

4.23. The Skilled Person found 38 unfair outcomes from the 100 customer files reviewed. The unfair treatment of customers by the Banks included:

(1) in 10 cases, failing to take sufficient steps to establish the individual customer circumstances;

(2) in 12 cases, failing to establish the customer's ability to afford a Payment Arrangement or, having established the customer's disposable income, putting in place an unaffordable Payment Arrangement;

(3) in 6 cases, failing to identify vulnerable customers or refer them to the appropriate team;

(4) in 14 cases, charging fees where it was inappropriate to do so or misinforming the customer about the fees that they would be charged; and

(5) in 10 cases, failings in respect of the Banks' communication with the customer, including miscommunication and taking inadequate steps to contact the customer once they had entered into arrears.

4.24. The Skilled Person's findings indicated that some of the failings that had previously been identified by the Authority, and reported to LBG as a result of the 2013 Thematic Review, continued into 2015 despite the steps taken by the Banks to address them. The Skilled Person's Report also identified a number of additional weaknesses within the Banks' secured collections and recoveries systems and controls. In response, the Banks generally accepted the Skilled Person's findings and affirmed their commitment to implementing a further programme of action to ensure better outcomes for their customers in financial difficulty.

Responsibility for customers in arrears and pre-arrears

4.25. The Banks' objective of the reorganisation referred to in paragraph 4.12 above was to deliver cost savings and provide better customer service by more skilled staff who were capable of handling both secured and unsecured collections. Following the reorganisation, the departments relevant to mortgage arrears handling and forbearance management are set out below.

(1) Credit Operations, which sat within Operations, was responsible for secured collections and recoveries. This included the management of the call handler teams that contacted customers in arrears. There were a number of different teams in Credit Operations that carried out different stages of the collections process including pre-arrears, collections, pre-litigation, litigation, evictions and properties in possession.

(2) The Business Unit Control Function ("BUCF") was an independent control function also within Operations. It worked alongside the other departments responsible for mortgage arrears to provide quality assurance.

(3) Credit risk policy for mortgages, including arrears management, was set by Mortgage Credit Risk ("MCR"). MCR was separate to Credit Operations. MCR set the credit risk polices and customer treatment strategies with which Credit Operations had to comply.

(4) Conduct, Compliance and Operational Risk ("CCOR") had an oversight function, providing independent assurance over the Banks' compliance control framework and the effectiveness of the first line of defence along with the Banks' compliance with policies owned by CCOR. CCOR owned the group's conduct risk policies governing the treatment of customers with

which the other group functions were required to comply. For instance, CCOR introduced the group customer treatment standards and standards applicable to customers in financial difficulty. However, the standards also made it clear that each business unit within the Banks (such as Credit Operations which dealt with customers in arrears) was responsible for identifying and managing its customer treatment risks.

4.26. Credit Operations implemented the policies set by MCR and was responsible for the fair treatment of customers, the identification and management of customers in financial difficulty, identifying appropriate solutions for such customers and monitoring fair customer outcomes.

4.27. By 2011, at the start of the Relevant Period, there were 773 staff undertaking secured collections and recoveries activities across six different sites. After secured collections and recoveries was moved into Credit Operations the number of sites was reduced to four, three of which handled customer calls. The reorganisation meant that a large amount of mortgage collections and recoveries expertise was lost and nearly all of the mortgage arrears call handlers were now new-to-role (although many had unsecured call handling experience).

Policies and process / Treating customers fairly

4.28. During the Relevant Period, the Banks used an LBG group wide policy framework to ensure that there was a consistent approach across the Banks. For most of the Relevant Period, the framework consisted of the following components:

(1) Principles: statements relating to the primary risks relevant to the group, setting the foundation for the group's behaviours and decision-making. There were two principles relevant to customers in arrears, called the "Credit Risk Principle" and (from January 2013) the "Conduct Principle".

(2) Policies and procedures: documents translating the principles into requirements, and detailing how the policies will be adhered to. The group had numerous policies relevant to its handling of customers in arrears.

(3) Business processes: These are the processes adopted by each individual business unit within the group in order to give effect to the policies and procedures. For example, in Credit Operations there were policies and

procedures detailing how customers should be contacted, how affordability should be assessed and the way mortgage arrears Payment Arrangements should be set and approved.

How the Banks handled customers in mortgage arrears

4.29. Key elements of handling customers who are in arrears, or are at risk of falling in arrears, include:

(1) making contact with affected customers with whom Payment Arrangements in respect of the arrears have not yet been made;

(2) obtaining relevant information to understand the customer's financial position and circumstances;

(3) where possible, agreeing with the customer an appropriate Payment Arrangement or alternative strategy; and

(4) keeping proper records of the information obtained and Payment Arrangements made.

4.30. The Banks developed policies and processes for contacting customers, including a "contact strategy" which was relevant both to the nature of contact made or attempted with customers, and the fees that would be charged for such contact. The contact strategy is discussed in paragraphs 4.34 to 4.37.

4.31. The Banks had a "Call Model" which their staff were to use during telephone calls with mortgage customers. Such calls were a key method of obtaining information and discussing and agreeing Payment Arrangements or other strategies with customers. In addition to the Call Model, the Banks had in place a "payment authority matrix" – also referred to as the "PAM" - which set out the minimum percentage of CMP which a colleague was authorised to accept as a Payment Arrangement without seeking further authority from a more senior colleague. The Call Model is discussed at paragraphs 4.38 to 4.42 and the nature and effect of the PAM at paragraphs 4.47 to 4.51.

4.32. In order to make appropriate Payment Arrangements or take other appropriate action, it is necessary for a mortgage lender to assess the customer's ability to meet their obligations under the proposed Payment Arrangement, and to understand and take into account the customer's circumstances. How the Banks assessed affordability is discussed at paragraphs 4.43 to 4.46. Their consideration of vulnerable customers is discussed at 4.65 to 4.67. We discuss the Banks' record keeping at paragraphs 4.68 to 4.70. Specific cases are discussed at paragraphs 4.56 to 4.64.

4.33. In the course of dealing with customers in any circumstances, firms are required to identify and respond to complaints in accordance with the Dispute Resolution: Complaints section of the Authority's Handbook ("DISP"). We discuss the Banks' handling of complaints by customers in mortgage arrears in paragraphs 4.71 to 4.74.

Contact Strategy and customer communication

4.34. During the Relevant Period, the Banks largely used an automated contact strategy to contact customers who were more than £50 in arrears with whom a Payment Arrangement had not yet been made. The nature and extent of contact depended on the Banks' customer risk assessment. The Banks would contact customers by letter, text message and by using an automated telephone dialler. In the case of customers that the Banks identified as not being suitable for automated contact, and some Bank of Scotland ("BoS") and Intelligent Finance customers, the Banks managed contact manually.

4.35. The Skilled Person considered that the Banks' contact strategy was not sufficiently risk-based and did not appropriately take into account different customer indicators (such as vulnerability) or characteristics (such as being self-employed or having irregular payment patterns). The Skilled Person considered that the automated process was not always appropriate for such customers.

4.36. The Skilled Person noted that the Banks' automated telephone dialler had a control such that no more than six attempts to call should be made per day per customer, where the Banks held two or more telephone numbers; and a maximum of three attempted calls where the Banks held only one contact number. However, there was no upper limit on the number of attempts per week or per month. The Skilled Person considered the strategy of continued use of the dialler over a longer period of time without successful customer contact to be inappropriate. In addition, there were cases in which the Banks continued to rely on the dialler where the contact numbers were discontinued or incorrect and/or there were sustained attempts at contact via the same telephone numbers over a long period of time without response. The Skilled Person considered that the Banks ought to have appreciated that a bespoke approach was necessary in such cases.

4.37. The contact strategy also dictated the levy of arrears management fees by the Banks. The charging approach adopted by the Banks was activity based, meaning that fees would be charged to customers whenever the Banks took an action such as writing certain letters. Customers who had agreed Payment Arrangements did not incur arrears management fees.

Call Models

4.38. The Banks could take a number of potential actions on the accounts of customers who were in mortgage arrears throughout the collection lifecycle, from pre-arrears through to repossession.

4.39. The Banks used Call Models, which were process flow maps, to guide the call handlers' discussion of the options during telephone contact with mortgage customers. Credit Operations had overall responsibility for creating and implementing the Call Models.

4.40. In 2009, prior to the Relevant Period, the Banks revised the Call Models for mortgage arrears handling so that they no longer concentrated on collecting the outstanding arrears balance as quickly as possible but instead focused on understanding the customer's circumstances to identify an appropriate solution for that customer.

4.41. In March 2011, the Call Model for mortgage arrears handling was revised so that it included a specific requirement to ask what was preventing the customer from paying, and to establish whether this was a long-term or short-term issue. In July 2012, this Call Model was revised again, for the first time expressly requiring call handlers to "*Fact find using questioning and account history / information to understand the customer's situation*."

4.42. The Call Model set out the Banks' high-level expectations of the type of information that a call handler should obtain from the customer, for example the Call Model in use during 2012 included sections to establish:

(1) whether the customer could pay the amount due;

(2) what was stopping the customer paying;

(3) what the customer could pay and when they could pay; and

(4) whether the issues were short or long term.

Assessing affordability

4.43. In order to establish the appropriate course of action when a mortgage customer is in financial difficulties, it is necessary for firms to obtain sufficient information about the nature of those difficulties and the customer's financial position overall.

4.44. During the majority of the Relevant Period, the Banks relied primarily on call handlers following the relevant Call Model as a means of obtaining an understanding of customers' financial and general circumstances. This did not involve a systematic examination of the kind that was involved in a formal income and expenditure assessment; rather call handlers were able to use their discretion within the scope of the Call Model to obtain sufficient information.

4.45. At the beginning of the Relevant Period, the Banks had a policy requirement for an income and expenditure ("I&E") assessment to be undertaken, but in August 2011 they identified that this was not always complied with in practice. Instead, an I&E assessment tended to be undertaken only when considering certain options. A 2010 pilot of the use of I&E assessments had indicated that in most cases they did not materially improve outcomes for customers and concluded that they should be used at the discretion of colleagues where appropriate. In response to the August 2011 finding of the gap between policy and practice and in light of the pilot findings, in December 2011 the Banks decided to amend the policy requirement to match practice, rather than bring practice into line with policy.

4.46. However, the Banks continued to assess the use of I&E assessments and, despite the 2010 pilot results, later reintroduced I&E assessments in December 2012 – although, again, it appears that these assessments were only required when considering certain customer treatments, rather than for all Payment Arrangements. It was only in January 2015 that I&E assessments were required prior to any Payment Arrangement.

Payment Authority Matrix

4.47. The Banks introduced the PAM in March 2011. The PAM set a minimum percentage of contractual monthly payment ("CMP") which a call handler could accept as a Payment Arrangement without obtaining approval from a more senior colleague. The PAM was intended to act as a framework of guidance for call handlers when setting Payment Arrangements and should have been applied only after the call handler had completed an affordability assessment.

4.48. Although more senior colleagues could approve call handlers agreeing deviations from the PAM, the circumstances where this could happen were limited to the following:

(1) the minimum litigation criteria were not met;

(2) there was a high likelihood of recovering the arrears within three months; or

(3) there were sensitive circumstances or an ongoing complaint.

4.49. The PAM made it relatively easy for call handlers to enter into Payment Arrangements which were within the criteria set by the PAM, irrespective of the customer's actual financial position.

4.50. The simplification programme that took place in 2012 resulted in a significant reduction in the number of call handlers experienced in mortgages collections and recoveries. Following the simplification programme, nearly all of the call handlers in mortgage collections and recoveries were new-to-role (although many had unsecured call handling experience). Call handlers who were new-to-role were more likely than their experienced predecessors to agree Payment Arrangements with customers in line with the minimum criteria in the PAM, rather than seeking to negotiate a Payment Arrangement which better matched what the customer could afford. As a result, there was a significant decline in the quality of Payment Arrangements:

(1) There was an increase in the number of Payment Arrangements in which customers paid less than the CMP. Such arrangements were permitted under the PAM. However, if customers can afford to pay more than the

CMP there is usually a benefit to them doing so, as they can clear their arrears more quickly and avoid paying unnecessary interest and charges. Conversely, paying less than the CMP will increase arrears and thus the interest and charges that customers are likely to have to pay. Instead of questioning customers to find out more about what they could afford to pay and seeking to negotiate a Payment Arrangement on that basis, call handlers appear to have been more likely simply to agree a Payment Arrangement based on the criteria in the PAM.

(2) There was also an increase in the number of accounts rolling into a further arrears cycle without a Payment Arrangement being made, indicating that call handlers were proving less efficient in making Payment Arrangements than previously.

4.51. The Banks introduced an amended version of the PAM in October 2012 in an effort to improve the Payment Arrangements being made. While the quality of Payment Arrangements had started to improve by December 2012, the amendments proved not to be sufficient and at one site where call handlers were based the quality of Payment Arrangements continued to deteriorate. The Banks, which by this stage were aware of the problem that call handlers were following the PAM rather than considering individual customer circumstances, made further changes in April 2013, and undertook a significant exercise to train call handlers to negotiate improved Payment Arrangements. This did result in a further improvement in Payment Arrangements.

Financial Assessment Unit

4.52. In addition to the amendments to the PAM discussed above, and in response to the Banks' concerns that call handlers were not obtaining sufficient financial information, the Banks established the Financial Assessment Unit ("FAU"), an offshore unit, separate to the core Collections and Recoveries team. The FAU was used to undertake detailed affordability assessments, or I&Es, and verify the income information provided by the customer. It only dealt with customers who could not repay arrears within six months, or were making a Payment Arrangement for less than their CMP. The objective was to enter into the best Payment Arrangements for customers as soon as possible. Planning for the unit commenced in February 2013, a pilot was run onshore in April 2013 and by June 2013 the offshore FAU was operating.

4.53. A consequence of the unit being separate from the usual Collections and Recoveries team was that the process of setting a Payment Arrangement became separate to that of undertaking the affordability assessment. Interim Payment Arrangements would be set up by the Collections and Recoveries call handler, based onshore, who would then, if the criteria for the FAU process applied, hand the customer to the FAU to complete an I&E and collect information to verify the assessment. If the customer did not have the information they were given a ‘grace period’ in which they could collect and provide the information required by the Banks. If the I&E resulted in a recommendation to amend the interim Payment Arrangement, the customer had to be transferred back to the onshore team for that Payment Arrangement to be put in place. This resulted in the customers having to have multiple calls with the Banks. As the customers were transferred between different departments, call handlers had to heavily rely on the notes taken by their colleagues.

4.54. The FAU was established at pace. A number of issues were identified during the onshore pilot. A review of 120 calls found that only 30% of calls were clear passes when assessed against the quality assurance criteria used by the Banks, 18% of the calls were assessed as a fail and a further 52% were considered a pass but with the call handler requiring further development. Despite this the FAU was approved by the Banks.

4.55. The FAU resulted in a significant increase in the number of complaints being made by customers. The Banks concluded that this was due to the increased amount of contact with customers. Changes were made to the FAU process to try to reduce the number of complaints. Additionally, in November 2013 a pilot was approved to undertake the affordability assessment within the normal collections and recoveries process. This approach was eventually adopted by the Banks and the FAU was disbanded in the third quarter of 2014.

Case reviews

4.56. The March 2015 Review (referred to in paragraph 4.18) included a review of 50 cases from 2011 to 2013 and an additional 10 cases from 2014. The Banks and the professional services firm that was engaged to provide quality assurance for this review agreed that the minimum level of an affordability assessment should include:

(1) net income;

(2) outgoings, including essential and non-essential;

(3) net disposable income;

(4) loans and/or overdrafts; and

(5) any predicted changes in the customer's circumstances.

4.57. The professional services firm identified that in 46 of the 50 cases from 2011 to 2013 which were reviewed, there were failures to undertake an adequate affordability assessment which met these standards.

4.58. In addition, the professional services firm identified that 8 of the 10 files reviewed from 2014 did not contain an affordability assessment that met minimum requirements as agreed between the Banks and the professional services firm. The cases had varying levels of missing information: for example, some did not assess affordability at all whilst others were found to only assess affordability sporadically. Others did not consider whether the customer's circumstances had changed.

4.59. Although the lack of an adequate affordability assessment did not necessarily result in an unfair outcome for the customer, the professional services firm correctly noted that in cases where the affordability assessment was insufficient, it was impossible to assess if a more appropriate action could have been taken. For example, it was not clear in the absence of an adequate affordability assessment if the Payment Arrangement was set at the correct level or whether the customer could have afforded to make a higher monthly payment which could have resulted in the customer rehabilitating their account sooner.

4.60. As noted in paragraph 4.22, the Skilled Person's review, which considered 100 files from 2014 and 2015, found that in 10 cases the Banks took insufficient steps to consider the mortgage account history, establish the customer's circumstances or probe further in scenarios where information provided by the customer required further questioning. Where call handlers did not properly determine customer circumstances they could not confirm whether the agreed Payment Arrangements were appropriate for customers or sustainable. This created a risk that a customer's circumstances were not considered, and that the outcome would not be fair.

4.61. The Skilled Person also found that in 12 cases the Banks either did not establish the customer's ability to afford a Payment Arrangement or, having established their disposable income, put in place an unaffordable Payment Arrangement.

4.62. The Skilled Person identified that no affordability assessment had been completed, or the affordability assessment had been calculated incorrectly, before a Payment Arrangement was put in place in 19 of the cases they assessed as unfair.

4.63. In some situations, the PAM required that a payment should be made immediately. The Skilled Person identified seven unfair cases where the call handler was focused on taking an immediate payment from a customer to reduce the amount of the arrears on the account as opposed to assessing individual customer circumstances and therefore putting in place an affordable and sustainable Payment Arrangement. This appears to have been driven by call handlers inflexibly following the PAM rather than exercising independent judgement. The consequence of refusing to enter into a Payment Arrangement was to leave the customer to accrue arrears, and risk further charges which were applied under the contact strategy because a Payment Arrangement was not in place (see paragraph 4.37 above).

4.64. The Authority provides below examples of the cases the Skilled Person found involved a failure to consider adequately the customers' circumstances to ensure a fair outcome:

(1) A call handler attempted to set up a Payment Arrangement with a customer who was on long-term sick leave, was behind on bills and had negative disposable income, by suggesting to the customer that they should ask their family for more funds. The call handler then included the funds from family members within the I&E assessment to reduce the customer's income deficit;

(2) A call handler failed to act on instructions received from a customer. The customer wanted to make a debit card payment but was told that the call handler was unable to take such a payment. Following this the customer asked whether the payment could be taken via direct debit and the

customer was advised that the direct debit had been reset for the following month. The customer believed that the direct debit for the following month had been reset to take two months' payments as per their instruction, but that is not what the call handler had done; and

(3) In two further instances the Banks failed to act on explicit instructions received from customers for the Banks to take possession of their property or failed to talk to the customer pre or post-surrender of the property to discuss alternative forbearance options, which may have been available to the customer dependent on their circumstances.

Failure to identify vulnerable customers

4.65. The Banks did provide training on identifying vulnerable customers during call handlers' induction training. However, this was not refreshed after their induction had been completed. As the Banks did not report failings in respect of the identification of vulnerable customers and the referral of vulnerable customers to the Customer Priority Team ("CPT") as part of their case reviews, there was nothing that prompted management to consider the provision of refresher training to the existing employees of the Banks.

4.66. The Skilled Person identified that call handlers also failed in six cases to identify vulnerable customers despite customers disclosing information during a call such as illness or divorce, which should have enabled the call handler to identify the customer as being vulnerable. Two examples of these cases are set out below:

(1) Customer A raised a number of vulnerability flags during calls with the Banks, which included a marital split and loss of employment. In addition, Customer A stated that their daughter had gone missing. During one call in 2015, Customer A referred to the issues that had been disclosed to the Banks as having an impact on their ability to afford the mortgage. Despite the disclosures on two separate occasions, Customer A was informed that a payment had to be made to their account before a Payment Arrangement could be put in place; and

(2) Customer B died and as a result his wife (Customer C) was in the process of obtaining probate over his estate. Customer C contacted the Bank to explain the situation. After obtaining probate, Customer C made one

mortgage payment successfully, however, the following month Customer C was unable to make a payment because the call handler could not obtain authority to take that payment. Despite Customer C becoming frustrated and distressed during the phone call, the call handler informed Customer C that “their hands are tied” and that they were unable to discuss anything. The delay in taking the payment would have resulted in additional interest accruing on the mortgage account.

4.67. In the above examples, the call handler failed to transfer the customers to the CPT, a specialist team at the Banks responsible for interactions with vulnerable customers.

Record keeping

4.68. The Banks were required to make and retain adequate records of dealings with customers whose accounts are in arrears, including recordings of all telephone conversations between the firm and the customer which discuss any amounts in arrears. Throughout the Relevant Period, the Banks failed consistently to retain adequate records of their dealings with customers who were in arrears, although they made improvements from 2014. Of particular significance, the March 2015 Review identified missing third-party correspondence, including reports or I&E assessments which recorded discussions of the reasons for arrears, the customer’s situation and affordability assessment.

4.69. Similarly, the Skilled Person found that there were failings in record keeping on 26 of the customer files that they reviewed. These included missing copies of letters that were sent to the customer by the Banks and missing recordings of telephone conversations. The level of missing information and the impact that it had on the outcome for the customer varied, with 13 of the 26 cases that had information missing assessed as unfair by the Skilled Person.

4.70. The missing records are significant because they should have been used to tailor customer interactions and to understand customers’ circumstances. Where information was missing from a customer’s record, future conversations risked not being tailored to the customer’s personal circumstances as information that had been obtained had been lost or not recorded.

Failure to identify customer complaints

4.71. As part of its quality assurance work in the March 2015 Review, the professional services firm identified that, in the calls it reviewed from 2011 to 2013, call handlers at the Banks failed to identify or report a complaint in 24 percent of cases reviewed, one of which included multiple instances of failures to report complaints.

4.72. The Skilled Person identified that call handlers failed to recognise a complaint in three of 14 cases (from a sample of 100 cases the Skilled Person reviewed) where the customer had expressed dissatisfaction during one of the interactions with the Banks. However, the Skilled Person found that there was nevertheless an overall fair outcome for the customer in two of these three cases.

4.73. In March 2015 the Banks' internal audit function ("Group Audit"), as part of an audit of complaint handling within Credit Operations, identified that the Banks did not provide sufficient guidance to employees, which meant there was a risk that employees at the Banks did not re-open complaints that should have been re-opened and that quality checking ("QC") performed by Credit Operations did not always identify where employees at the Banks were not following complaint procedures.

4.74. Where customers expressed dissatisfaction in calls and the call handler failed to identify it as a complaint the Banks would not have been able to record or investigate the complaint.

The Banks' risk management model

4.75. The Banks operate a control environment using a "three lines of defence" risk management model (described below) and did so throughout the Relevant Period:

(1) The first line of defence ("1LOD") involves "risk management" and is carried out by the relevant business line. The business line has primary responsibility for risk decisions, measuring, monitoring and controlling risk within the business unit. They are required to establish effective governance and control frameworks for their business compliant with group policy requirements and to act within group risk appetite parameters set and approved by the Board;

(2) The second line of defence ("2LOD") involves "risk oversight" and is carried out by the Risk Division. The Risk Division is responsible for, amongst other things, providing oversight and independent challenge to the effectiveness of risk decisions taken by business management, reviewing, challenging and reporting on the risk profile of the group and ensuring that mitigating actions are appropriate; and

(3) The third line of defence ("3LOD") involves "risk assurance" and is carried out by the Group Audit function. Group Audit is responsible for providing independent, objective assurance that the Banks' risk management, control and governance processes are effective.

4.76. For most of the Relevant Period, the 1LOD for the Banks' mortgage arrears handling activities was performed by Credit Operations with support from BUCF.

4.77. The 2LOD was performed by the Risk Division. This included MCR and, from November 2011, CCOR. As noted in paragraph 4.26 above, MCR set the credit risk policies with which Credit Operations had to comply and was responsible for designing detailed customer treatment strategies which appropriately managed CiFD. CCOR was responsible for providing independent assurance over the effectiveness of the 1LOD and the Banks' compliance control framework, its monitoring activities and the Group's compliance with policies owned by CCOR, which included the conduct risk policies governing the treatment of customers. CCOR also provided oversight and assurance to Credit Operations using a risk-based approach and provided input on the design of certain policies.

Outcomes Testing

4.78. At the start of the Relevant Period, interactions with customers in mortgage arrears were monitored by the 1LOD through QC. This involved:

(1) Team Captains checking a sample of calls made by call-handlers within their teams for compliance with the Call Model; and

(2) The Remote Listening Unit ("RLU"), which was independent of call handlers' line management:

(a) checking a sample of customer calls for quality, adherence with the Banks' policies and procedures, and fairness; and

(b) carrying out 'calibration' checks of the Team Captains' checking to ensure a consistent standard of 'front-line' quality checking.

4.79. Throughout 2011, the Banks carried out significant work developing their conduct risk policies and procedures. This included introducing a requirement for business units to implement Outcomes Testing to assess whether customers were receiving fair outcomes from the Banks.

4.80. The Group Outcome Testing Standards set out five factors (referred to as "areas of focus") against which each call should be considered to ascertain whether a customer outcome was fair, namely "Decision", "Recognition and Access", "Fact-Finding", "Communication" and "Timeliness".

4.81. The Group Outcome Testing Standards required cases to be graded with one of three "Outcome Results", namely:

(1) "Pass – fair outcome"; a fair customer outcome was achieved and internal processes, procedures and policies were followed;

(2) "Fail – unfair outcome (individual)": an unfair customer outcome occurred due to failure of the call-handler to follow internal processes, procedures and policies; and

(3) "Fail – unfair outcome (process)": an unfair customer outcome occurred due to requirements of a process, procedure, policy or system requirement.

4.82. The "Decision" score, which assessed whether the outcome was "*realistic and appropriate given the customers' circumstances*", was assessed independently of the other four areas of focus. Because of this separation, it was theoretically possible for the "Decision" to be deemed fair for the customer, despite weaknesses in, for example, the "Fact-Finding" element of the call. However, the Group Outcomes Testing Standards provided that a fair customer outcome would only be achieved if each of the five areas of focus were achieved and stated that "*a failure to achieve any element will result in an unfair outcome overall*".

4.83. The 1LOD started Outcomes Testing for mortgage arrears handling in October 2011 (in addition to QC activities, which continued). Outcomes Testing was initially conducted by the RLU. From January 2012, the BUCF also started

Outcomes Testing 20 calls per month. From April 2012, Team Captains also conducted Outcomes Testing.

4.84. CCOR started continuous monitoring of the 1LOD's Outcomes Testing in February 2014.

Failure properly to appreciate impact of fact finding failures on fairness of outcomes

4.85. When conducting Outcomes Testing during most of the Relevant Period, the Banks did not recognise that, where there had been failings in investigating customer circumstances and thus assessing affordability, it was not possible to be sure that the outcome for the customer was fair.

4.86. After the introduction of Outcomes Testing by the 1LOD in late 2011, the results for both fair "Decision" outcomes and "Other" outcomes (which included the other four areas of focus, see paragraph 4.82 above) were consistently high throughout 2012 and 2013.

4.87. In the small number of cases where the 1LOD's Outcomes Testing identified unfair customer outcomes this was often cited as being due to weaknesses in fact finding and assessment of affordability of arrangements by call-handlers. For example, narrative comments, explaining that most of the "fails" reported in relation to "Decision" were because of call-handlers not asking questions to sufficiently understand the customer's current circumstances and affordability, were included in MI packs reporting the results of Outcomes Testing by the RLU and Team Captains in each month between August 2012 and September 2013 (inclusive).

4.88. However, in other cases the 1LOD's Outcomes Testing in 2012 and 2013 identified that call-handlers were failing to sufficiently understand customers' circumstances, but nonetheless assessed the calls as resulting in "fair" customer outcomes.

4.89. For example, 1LOD Outcome Testing results for March, April, May, June and July 2013 in respect of Outcome Testing of calls with Customers in Financial Difficulty ("CiFD") (which included customers in mortgage arrears as well as customers with unsecured debt arrears) recorded approximately 97-98% fair "Decision" outcomes and 97-98% fair "Other" outcomes, despite also highlighting that significant numbers of call handlers were deemed to have development needs relating to how they conducted fact finding. For example, in the same period between 25% and 30% of call handlers were reported to have development needs in relation to "Fact Finding" and between 15% and 21% were reported to have development needs in relation to "Decision". Narrative comments in MI packs explaining these results state: "*The majority of [Pass Development] scores [for "Decision"] are awarded due to colleagues not asking sufficient questions within the Situation / Fact Find of the call, which means it can not be ascertained whether the Resolution reached is the most appropriate or not as we do not understand enough about the customers financial position*".

4.90. The BUCF started conducting Outcome Testing from January 2012 with a sample of 20 cases per month. This was intended to provide assurance regarding the effectiveness of the RLU checking.

4.91. The BUCF test results in 2012 and 2013 also reported high levels of fair outcomes. However, in common with the RLU, the BUCF also assessed calls where they had identified that call-handlers had failed to sufficiently understand customers' circumstances as resulting in "fair" customer outcomes. For example, the BUCF tested 26 calls in September 2012 and reported 100% "fair" outcomes for "Decision" despite also noting that in four cases: "*Agents have not fully investigated the customer circumstances and additional information may affect the agreed arrangement*".

4.92. This deficiency in the 1LOD's approach to Outcomes Testing was not identified by the 2LOD or 3LOD.

4.93. In Q4 2011 CCOR (2LOD) undertook a review to assess the extent to which the 1LOD's Outcomes Testing methodology was aligned to the Group Outcomes Testing Standards. As part of the review, CCOR reviewed a sample of 30 calls and file reviews which had been tested by the 1LOD. The final report produced on 8 December 2011 stated that CCOR considered the 1LOD's framework for Outcomes Testing to be "*closely aligned*" to the Group Outcomes Testing Standards and agreed with 28 out of 30 of the 1LOD's assessments of the calls tested, explaining that the two cases with reported differences were differences in interpretation of the application of guidelines rather than substantive failings of Credit Operations' Outcomes Testing framework.

4.94. The report did highlight some areas for improvement, however, including that the call scoring guidance used by the 1LOD should provide more explicit guidance on what constituted a fair customer outcome. A detailed version of the report dated 1 December 2011 stated that:

"*The effectiveness of guidance would be maximised by encouraging Quality Assurance assessors to consider each element of the call model and the impact on overall fairness of the outcome, considering the materiality of any findings [...] NOTE: The Standards currently require an unfair customer outcome to be recorded where any of the five predefined elements fail.*"

4.95. A subsequent version of the report issued on 8 December 2011 listed the management actions agreed to address this issue. These included updating guidance documents to "*show how individual call element outcomes (i.e. situation, resolution etc), and their materiality, will influence the overall outcome*".

4.96. Although this action was tracked and noted as having been completed by Credit Operations, no material amendments were made to the relevant document. It appears CCOR did not verify the actions it had recommended in the report were closed out.

4.97. Group Audit conducted an audit towards the end of 2012 which reviewed the simplification programme begun in that year (see paragraph 4.13 above) and the control framework in place to ensure that secured collections performance and compliance with conduct risk standards were maintained. The final report was issued in February 2013 and stated that some "*newly recruited and new in role*" call-handlers were "*not yet properly establishing a customer's financial situation to enable them to negotiate affordable payment arrangements that will stick. As a consequence, there is currently a risk that arrangements are not made in the best interest of the customer or the Group*". The report also stated that the 1LOD's Outcomes Testing approach "*does not adequately highlight where colleagues were failing to treat a customer properly*". However, the report's findings and recommendations appear to have focused more on the 1LOD's failure to adequately highlight call-handlers' development needs, resulting in missed opportunities to provide tailored training and support to call-handlers, rather than suggesting that 1LOD's approach to Outcomes Testing was over-stating the number of fair customer outcomes.

4.98. In response to concerns raised by the Authority, in February 2014, CCOR began continuous monitoring of the 1LOD's Outcomes Testing. The continuous monitoring considered the 1LOD's Outcomes Testing results for the previous month. The results of the monitoring were presented in a "Final Report" and sent to individuals in functions including Credit Operations, the BUCF and CCOR. The Final Reports included raw data and commentary on the 1LOD and 2LOD testing and a comparison of the two.

4.99. The effectiveness of the 1LOD Outcomes Testing was determined by CCOR by way of comparison with CCOR's own 2LOD Outcomes Testing. In some months in the period February 2014 to January 2015 (inclusive), CCOR reported divergences between CCOR and the 1LOD's results for Fair Outcome "Overall" and Fair Outcome "Decision" of between 5.5% and 9.5%. In some cases it was noted that the divergences were due to the 1LOD not identifying insufficient fact finding by the call-handler. However, the Authority notes that the divergences between the 1LOD and 2LOD's results were not large. These results do not appear to have alerted the Banks to the fact that the 1LOD's Outcomes Testing might be over-stating the number of fair outcomes as a result of a failure properly to appreciate the impact of weaknesses in fact finding on the Banks' conclusions as to the fairness of customer outcomes.

4.100. Between August and December 2014, the Banks also reviewed their implementation of their Arrears and Forbearance policies across a sample of 60 cases for customers who entered the collections process between 2011 and 2014 (see paragraph 4.18 above). Initial Outcomes Testing by the 1LOD concluded that 100% of the cases reviewed had resulted in fair customer outcomes; after subsequent testing by the 2LOD and 3LOD, this was revised to 94%, indicating a high level of agreement between the three lines of defence.

4.101. In presenting the findings to the Authority, the Banks explained that although all three lines of defence agreed that "*the vast majority*" of customers received "*an overriding appropriate outcome*", it had identified that:

"*c.90% of cases could have demonstrated a more robust level of Affordability Assessment that meant a sub-cohort of these customers may have agreed impractical arrangements and some of these may then have been inappropriately charged fees upon breaking those arrangements.*"

4.102. The Authority considers that the results of the Outcomes Testing conducted by the three lines of defence in the March 2015 Review were the product of a failure by each of them to properly appreciate the impact of weaknesses in fact finding and affordability assessment on the fairness of customer outcomes. It was not appropriate for the Banks to conclude that 94% of customers had received fair outcomes where they were not sure if some of those customers had agreed impracticable arrangements because of a failure by the Banks to conduct an appropriate affordability assessment.

4.103. The professional services firm referred to in paragraph 4.56 above identified failures with regard to compliance with MCOB 13.3.2A (i.e. the affordability assessment) in 92% of the cases reviewed in the March 2015 Review which entered the collections process between 2011 and 2014 and 80% of cases which entered the collections process in 2014. They also concluded that 92% of customers had received fair outcomes but this finding was only reached on the basis that where breaches of regulation had resulted in charges being applied to the customer's account, the Banks would be refunding the charges as part of the proposed remediation exercise (see paragraph 4.122 below). This conclusion also failed to reflect the reality that where there were failings in the affordability assessment, it was not possible to know whether appropriate Payment Arrangements had been made.

4.104. As a result of the findings of the March 2015 Review, on 28 April 2015 the Banks proposed a proactive remediation exercise to refund customers for broken payment arrangement fees and associated charges (see paragraph 4.123 below).

4.105. There is evidence that following the March 2015 Review, the Banks' approach to Outcomes Testing started to better take into account the impact of weaknesses in fact finding on the fairness of customer outcomes. For example, between June and December 2015, CCOR testing of outcomes for CiFD (which included CiFD in mortgage arrears) started to report higher numbers of unfair outcomes. Specific results for CiFD in mortgage arrears from testing in August 2015 and November 2015 were included in reports in November 2015 and December 2015, respectively, and indicated fair outcomes for "Meets Customer Needs" (which had replaced the "Decision" area of focus) of 94.7% and 78.1%. The November 2015 report identified some key recurring themes, including "Incorrect/inappropriate I&E [income and expenditure assessments] or Fact Finds" and stated:

"*During 2015 this has been noted as an issue across most [customer critical interactions] and is one the main contributing factors to the overall position for MCN being below risk appetite in both the 1st and 2nd LOD results since our May 2015 report*".

4.106. The Authority notes that at the same time the Banks were also making changes to their approach to mortgage arrears handling to address concerns raised by the Authority. Accordingly, improvements in the Banks' approach to Outcomes Testing may have resulted in higher numbers of unfair outcomes being reported than previously while fewer customers were in fact receiving unfair outcomes than previously.

Outcomes Testing only reviewed single interactions with customers

4.107. Until January 2015, the Outcomes Testing completed by the Banks reviewed single interactions with customers rather than taking a holistic view of the whole customer experience whilst in the mortgage arrears collections process. This approach did not provide senior management of the business with a view of the overall customer experience and so could only provide limited assurance about the quality of customer treatment. This created a risk that the Banks would be unable to identify potential or actual customer detriment.

4.108. In response to feedback from the Authority in January 2014 and April 2014, the Banks took steps to address this. From January 2015, the Customer Experience Team started "end-to-end" testing of ten cases per month. This involved listening to ten calls and reviewing the customer's file back to the origination of the customer's financial difficulties. However, this limited testing, which was within the 1LOD only, did not form part of a formal monitoring process and the resultant MI was not widely distributed.

4.109. The Banks subsequently built an end-to-end customer assessment which includes both retrospective and forward-looking tests and is carried out by the BUCF. This work was completed in 30 September 2015.

Management Information

4.110. The management information ("MI") produced from the results of Outcomes Testing was widely reported to management committees within Operations and Risk.

4.111. Senior management took comfort from the largely "green" RAG-rated results which were reported. In addition, narrative comments in MI packs indicated that the "fails" that were reported were being addressed by management through, for example, training initiatives. However, when senior committees were told of failings in fact finding as early as May 2012, there was a significant delay in implementing the appropriate remedial action, with negotiation training not being implemented until almost a year later. This was because of the simplification programme in 2012, which put pressure on trainers' ability to develop and deliver the new training programme.

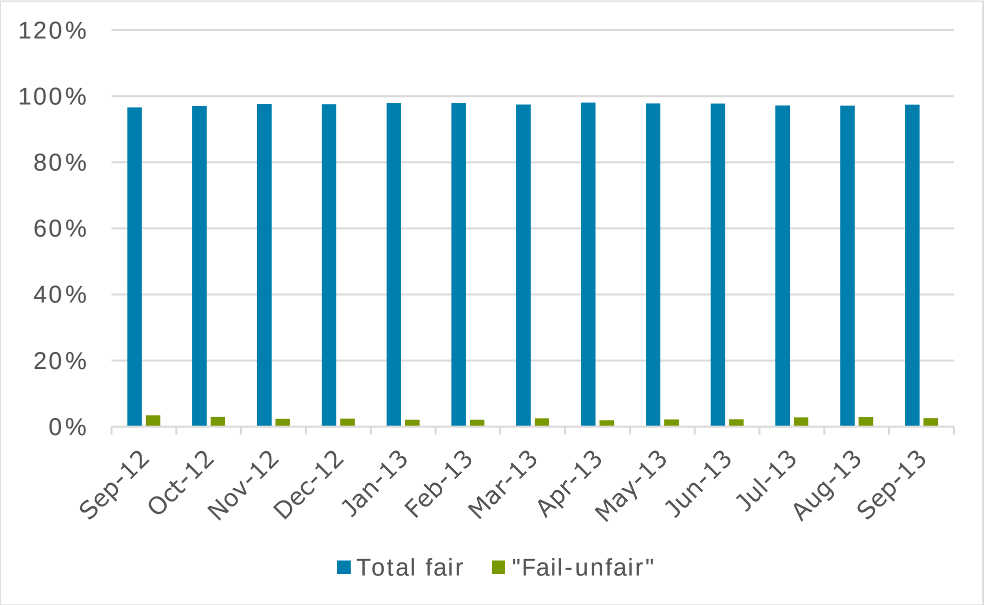
4.112. As noted at paragraph 4.81 above, the Group Outcome Testing Standards required cases to be graded "Pass – fair outcome" only where the requirements of all five areas of focus were met; otherwise the cases would be graded as "Fail – unfair outcome". During a discussion session on Outcomes Testing in October 2011 involving Credit Operations, the BUCF (1LOD) and Conduct Risk (2LOD), concerns were raised that this requirement was resulting in "*artificially low*" fair outcome rates for conduct risk testing. This was because cases where a fair customer outcome had been achieved but the call-handler had failed to follow internal processes, procedures or policies would be graded as "*Fail – unfair outcome due to failure to follow internal processes, procedures or policies*".

4.113. In a follow-up email on 14 October 2011, Conduct Risk stated that this "*should not be the case*" and that if a fair customer outcome had been achieved the case should be reported as "Pass – Fair Outcome" under the Group Outcome Testing Standards. They also stated that such cases could be recorded at a local level as "Fail – Fair Outcome", but should be combined with cases graded "Pass – Fair Outcome" and reported as a single figure when reported upward. Subsequently the BUCF amended its Outcomes Testing checklist so that "Fail – Fair" was a distinct outcome.

4.114. In addition to this, between August 2012 and September 2013, 1LOD Outcomes Testing results were presented in MI packs on an aggregated basis for both secured and unsecured lending collections and recoveries; this may have made it more challenging for committees reviewing the MI to drill down into the results for mortgage arrears handling.

4.115. Although the 1LOD's Outcomes Testing resulted in a significant percentage of "Fail – Fair" outcomes that were reported in MI Packs between September 2012 and September 2013, this was not visible to senior business and risk committees who only received a single "Fair Decision" figure. If cases which were graded "Fail - Fair" had been reported as such (or as "Fail – Unfair" in accordance with the Group's Outcome Testing Standards), it is possible that the senior committees which provided oversight of the Banks' mortgage arrears handling business and associated conduct risk would have challenged the 1LOD's rationale for concluding that a significant number of fair customer outcomes were being achieved despite call-handlers failing to follow internal processes, procedures and/or policies.

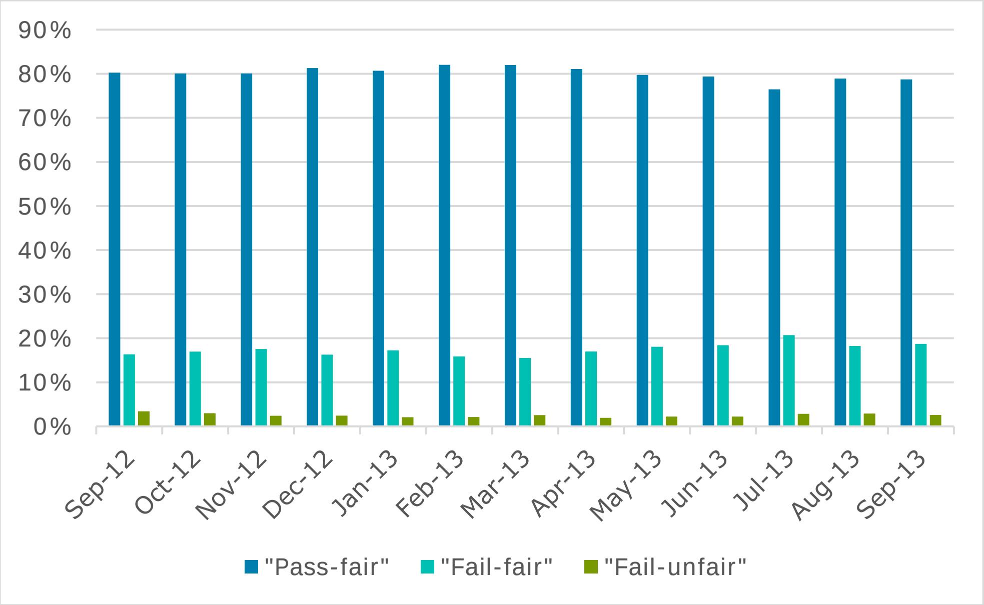
Figure 1: Comparison of cases reported as "Fair" compared to "Unfair" as a percentage of the total cases reviewed by the first line of defence (September 2012 to September 2013).



4.116. Figure 1 shows the high percentage of cases that were interpreted by the Banks as "Fair" in comparison with the small percentage of cases recorded as "Fail-unfair" between September 2012 and September 2013. This demonstrates the impression given to senior management that the majority of customers were receiving 'fair' outcomes.

4.117. Figure 2 below shows the comparison between cases graded as “pass-fair”, “fail-fair” and “fail-unfair” for September 2012 to September 2013, which demonstrates the extent of “fail-fair” calls that were not visible to senior management during this time-period.

Figure 2: Comparison of cases reported as “Pass-fair”, “Fail-Fair” and “Fail-Unfair” as a percentage of the total cases reviewed by the first line of defence (September 2012 to September 2013)



4.118. The Banks stopped using the “Fail – Fair” grade in January 2015 when they introduced a new framework for 1LOD Outcomes Testing.

4.119. The Skilled Person reviewed the Banks’ mortgage arrears and forbearance handling function and practices covering the period from January 2014 to 31 August 2015. The Skilled Person made findings in relation to the Banks’ MI for this function including that:

(1) The MI was focused on QC scoring and the RAG status of the Outcomes Testing “areas of focus” plus the RAG scoring of complaints, which meant that it was reactive and limited in nature. There was no MI which attempted to identify issues before they had crystallised and therefore were evident through testing;

(2) The commentary in the MI packs was limited and did not include root cause analysis of reasons for failures identified by the testing;

(3) Where an “area of focus” was scored red in successive reports the MI packs did not demonstrate an acknowledgement of this, and gave no indication of action being taken above and beyond the actions detailed for individual cases; and

(4) Committees with a focus on arrears handling received reports on conduct risk at an aggregate level. As a number of metrics were consolidated for reporting purposes, there was the possibility that potential issues could be hidden or masked by better results in other areas, i.e. each area of focus covered (and aggregated) a number of questions together and therefore if the results of the testing on some questions was sufficiently positive then this might obscure a negative outcome elsewhere.

4.120. As a result of the Skilled Person’s findings and recommendations, the Banks made changes to their MI including:

(1) Introducing in 2016 a broader set of Conduct Risk Appetite Metrics (“CRAMs”). CRAMs had first been introduced in 2013 as conduct risk measures to identify conduct issues before they crystallised;

(2) Taking steps to improve the commentary in MI packs to ensure that it is sufficient to enable informed debate around RAG status, root causes and themes and trends; and

(3) Reviewing the way MI is reported to ensure that an appropriate level of detail is available for each level of committee in the Banks’ governance structure and that data is reviewed on a disaggregated basis where this is appropriate for the committee in question. A forum established in Q4 2015, the Credit Operations Performance & Conduct Committee, receives MI on a disaggregated basis to enable it to review low-level detail and drive discussion around the root cause of results.

Improvements and redress

4.121. In response to feedback from the Authority in 2014, the Banks took a number of steps to address the Authority’s concerns regarding their approach to mortgage arrears handling. These steps included, for example, implementing continuous monitoring of the 1LOD’s Outcomes Testing by the 2LOD and introducing end-to-end Outcomes Testing (see paragraphs 4.98 and 4.108 above). Since the publication of the Skilled Person's report on 21 December 2015, the Banks have improved their systems and controls for mortgage arrears handling.

4.122. In June 2017, the Skilled Person completed a further review of the changes made by the Banks and reviewed 200 customer files for customers who entered the collections process between 1 November 2016 and 31 March 2017. The Skilled Person concluded that the Banks had made good progress in respect of their approach to the governance and management of secured collections. Some customer files that were reviewed by the Skilled Person still showed some unfair treatment of customers (12%), however, this figure was significantly less than that which was identified by the Skilled Person in 2015 (38%). The Banks continue to work on embedding the changes and making further improvements.

4.123. On 27 July 2017, LBG announced that it would refund all fees charged to mortgage customers for arrears management and broken Payment Arrangements, unpaid direct debit fees, returned cheque fees and field agent fees from 1 January 2009 to January 2016. This includes customers of the Banks. The redress scheme extends to refund of litigation fees charged between January 2011 and September 2016 if applied unfairly or, in certain circumstances, automatically. LBG also offers payments for potential distress and inconvenience and consequential loss which customers may have experienced as a result of not being able to keep up with unsustainable repayment plans. LBG also took steps to identify whether the relevant customers in the cases considered by the Skilled Person had suffered detriment and, where appropriate, to redress those customers.

4.124. The redress scheme will also refund the accrued interest on all fees up to the remediation date (unless there is a shortfall following repossession) or where customers had already paid the fees up until the date the fees were paid. LBG is contacting customers proactively, meaning that customers do not have to take any action until they are contacted by LBG. In March 2020, LBG estimated that approximately 526,000 customers would receive redress payments totalling approximately £300 million. LBG also voluntarily suspended the use of broken payment arrangement fees from October 2014 and all arrears management fees in respect of secured collections at the end of January 2016.

4.125. Although there were challenges in finalising the initial scope of the remediation exercise, the Banks established an extensive and proactive exercise that remediates customers during a term that is considerably longer than the Relevant

Period, irrespective of whether there was an unfair outcome in individual cases. There were also difficulties and delays encountered in the delivery of the final subset of customers captured by the exercise and who had been subject to litigation, affecting around 117,400 customers. However, the Banks will ultimately have repaid an amount significantly in excess of that which they earned in fees and interest on arrears balances during the Relevant Period.

4.126. Shortly after the Authority commenced its investigation, the Banks promptly and voluntarily commissioned a law firm to conduct a review into the matters referred to in this notice. The Banks voluntarily provided the report produced (including the underlying materials) to the Authority.

5. FAILINGS

5.1. The regulatory provisions relevant to this Final Notice are referred to in Annex A.

5.2. Based on the facts and matters above, the Banks breached Principles 3 and 6, as explained below.

Breaches of Principle 3: Treatment of customers

5.3. Principle 3 requires that a firm take reasonable care to ensure that it has organised its affairs responsibly and effectively, with adequate risk management systems.

5.4. During the Relevant Period, for the reasons explained below, the Banks' systems and controls for assessing affordability and entering into appropriate Payment Arrangements with customers in mortgage arrears were inadequate and accordingly breached Principle 3.

(1) Throughout the Relevant Period, the Banks' call handlers were not consistently obtaining adequate information to assess customers' circumstances to ensure that they were treated fairly. The Banks systems and procedures for gathering information from customers in order to assess affordability provided for a significant degree of discretion for call handlers. While this was not inappropriate, it created a risk that call handlers would not obtain sufficient information adequately to assess

customer circumstances. This risk was capable of being managed through appropriate training and monitoring.

(2) The PAM was intended to be a tool to help call handlers make Payment Arrangements, but it could be used inflexibly, with the resulting risk that call handlers may fail to negotiate appropriate Payment Arrangements. Again, this was a risk that could have been managed.

(3) As a result of the simplification programme in 2012, through which mortgage arrears handling and unsecured arrears handling were combined, the risks inherent in the Banks' systems identified above increased considerably. A large amount of mortgage collections and recoveries expertise was lost and nearly all of the mortgage arrears call handlers were new-to-role (although many had unsecured call handling experience). Call handlers inexperienced in mortgage arrears handling were more likely to rely on the PAM to inform the Payment Arrangements they entered into, and less likely to undertake the required investigation of customer circumstances. This resulted in a significant reduction in the quality of Payment Arrangements.

(4) The March 2015 Review identified failings in affordability assessments in 46 out of 50 files from the period 2011 to 2013 and 8 out of 10 files from 2014. The Skilled Person's review also identified failings in affordability assessments and inappropriately inflexible application of the PAM in files from 2014 and 2015. These findings show that the risks inherent in the Banks' systems were not adequately managed.

5.5. During the Relevant Period, the Banks' systems and controls in respect of their treatment of vulnerable customers in mortgage arrears were inadequate and accordingly breached Principle 3. This was because the Banks failed:

(1) to provide refresher training to call handlers on identifying and dealing with vulnerable customers; and

(2) did not adequately review whether call handlers were properly identifying vulnerable customers.

5.6. The Banks' systems and controls in respect of customers in mortgage arrears were also inadequate and accordingly breached Principle 3 in the following respects:

(1) The Banks did not have adequate systems for record keeping for the reasons given in paragraphs 4.68 to 4.70 above; and

(2) During the period 2011 to 2013, there were failings in the identification of complaints for the reasons given in paragraphs 4.71 to 4.74 above.

Breaches of Principle 6

5.7. Principle 6 requires firms to pay due regard to the interests of their customers and to treat them fairly.

5.8. During the Relevant Period, the Banks' breaches of Principle 3 identified above created a risk of unfair treatment of customers. That risk crystallised at the very least in the instances of unfair treatment identified by the Skilled Person.

Breaches of Principle 3: Oversight

5.9. During the Relevant Period, for the reasons explained below, the Banks' systems and controls for monitoring and oversight of Payment Arrangements with customers in mortgage arrears were inadequate and accordingly breached Principle 3.

(1) When conducting Outcomes Testing the Banks did not recognise that, where there had been failings in investigating customer circumstances and thus assessing affordability, it was not possible to be sure that the outcome for the customer was fair.

(2) Until January 2015, the management information produced by the Banks reported as "fair outcomes" cases which included failures to properly investigate customer circumstances and assess affordability. In addition, the management information did not include sufficiently prominent analysis of themes in outcome testing results or sufficient clarity as to the prevalence and impact of those themes. As a result, management did not identify that there were ongoing failings in this area and therefore a risk of unfair treatment of customers.

(3) Until January 2015, the Outcomes Testing undertaken by the Banks reviewed single interactions with customers and thus failed to take a holistic view of the interactions with the customer. As a result, it could only provide limited assurance about the quality of customer treatment, and created a risk that the Banks would be unable to identify potential or actual customer detriment.

5.10. The Authority therefore considers it is appropriate and proportionate in all the circumstances to take disciplinary action against the Banks for their breaches of Principles 3 and 6 during the Relevant Period.

6. SANCTION

Financial penalty

6.1. The Authority's policy for imposing a financial penalty is set out in Chapter 6 of DEPP. In determining the financial penalty, the Authority has had regard to this guidance.

6.2. In respect of conduct occurring on or after 6 March 2010, the Authority applies a five-step framework to determine the appropriate level of financial penalty. DEPP 6.5A sets out the details of the five-step framework that applies in respect of financial penalties imposed on firms.

Step 1: disgorgement

6.3. Pursuant to DEPP 6.5A.1G, at Step 1 the Authority seeks to deprive a firm of the financial benefit derived directly from the breach where it is practicable to quantify this.

6.4. The Authority has not identified any financial benefit derived by the Banks directly from the breaches.

6.5. Step 1 is therefore £0.

Step 2: the seriousness of the breach

6.6. Pursuant to DEPP 6.5A.2G, at Step 2, the Authority determines a figure that reflects the seriousness of the breach. Where the amount of revenue generated by a firm from a particular product line or business area is indicative of the harm or potential harm that its breach may cause, that figure will be based on a percentage of the firm's relevant revenue. The firm's relevant revenue will be the revenue derived by the firm during the period of the breach from the products or business areas to which the breach relates.

6.7. The Authority considers that the revenue generated by the Banks from their mortgage customers who were exposed to the risk of being treated unfairly is indicative of the harm or potential harm caused by the Banks' breaches. The Authority has therefore determined a figure based on a percentage of the Banks' relevant revenue. The Banks' relevant revenue is the revenue derived by the Banks from their mortgage customers in arrears, while their accounts were in arrears, during the Relevant Period. The Relevant Period of the Banks' breaches is from 7 April 2011 to 21 December 2015. The Authority has determined that the Banks' relevant revenue for this period to be £1,524,924,670.

6.8. In deciding on the percentage of the relevant revenue that forms the basis of the Step 2 figure, the Authority considers the seriousness of the breach and chooses a percentage between 0% and 20%. This range is divided into five fixed levels which represent, on a sliding scale, the seriousness of the breach; the more serious the breach, the higher the level. For penalties imposed on firms there are the following five levels:

Level 1 – 0%

Level 2 – 5%

Level 3 – 10%

Level 4 – 15%

Level 5 – 20%

6.9. In assessing the seriousness level, the Authority takes into account various factors which reflect the impact and nature of the breach, and whether it was committed deliberately or recklessly. The factors that the Authority has determined to be relevant to the Banks' breaches are set out below.

Impact of the breach

6.10. The Authority has not identified any benefit gained by the Banks from the breaches, nor any loss avoided, or intended to be gained or avoided.

6.11. The breaches involved a risk of loss to individual consumers, in that there was a risk that inappropriate treatment of customers could have caused them to incur fees and/or to remain in arrears for longer than necessary.

6.12. There was a risk that the breaches would affect vulnerable people, as a substantial proportion of customers in arrears are likely to be vulnerable.

Nature of the breach

6.13. The breaches persisted for a period of four years and eight months.

6.14. The breaches revealed systemic weaknesses in the Banks' internal systems and controls relating to making Payment Arrangements with customers in mortgage arrears.

Level of seriousness

6.15. DEPP 6.5A.2G(11) lists factors likely to be considered 'level 4 or 5 factors'. The Authority considers the following factors to be relevant:

(1) The breaches caused a significant risk of loss to individual consumers who went into arrears during the Relevant Period; and

(2) The breaches revealed systemic weaknesses in the Banks' internal systems and controls relating to making Payment Arrangements with customers in mortgage arrears.

6.16. DEPP 6.5A.2G(12) lists factors likely to be considered 'level 1 factors', 'level 2 factors' or 'level 3 factors'. Of these, the Authority considers the following factors to be relevant:

(1) little, or no, profits were made or losses avoided as a result of the breaches, either directly or indirectly;

(2) the breaches were committed inadvertently; and

(3) there is no evidence that the breaches indicate a widespread problem or weakness in the Banks beyond their systems and controls used by collections and recoveries in respect of Payment Arrangements with customers who are in arrears.

6.17. Taking all of these factors into account, the Authority has determined the seriousness of the Banks' breaches to be level 3 and so the Step 2 figure is 10% of £1,524,924,670.

6.18. Step 2 is therefore £152,492,467.

Step 3: mitigating and aggravating factors

6.19. Pursuant to DEPP 6.5A.3G, at Step 3 the Authority may increase or decrease the amount of the financial penalty arrived at after Step 2, but not including any amount to be disgorged as set out in Step 1, to take into account factors which aggravate or mitigate the breach.

6.20. The Authority considers that the following factors aggravated the Banks' breaches:

(1) The Authority had previously issued eight Final Notices to Lloyds TSB Bank plc (now known as Lloyds Bank plc), Lloyds Bank plc, and Bank of Scotland plc. Seven of the eight Final Notices involve Principle 3 breaches and two involve Principle 6 breaches. None of the prior Final Notices concern similar failings to those identified in this Notice.

(2) The Authority issued published guidance on arrears handling on several occasions in the years prior to and during the Relevant Period including examples of good and bad practice. The Authority also published a Final Notice against Yorkshire Building Society on 28 October 2014 for similar arrears handling weaknesses.

6.21. The Authority considers that the following factors mitigate the breach:

(1) The Banks acknowledged the failings raised by the Authority and have undertaken an extensive redress exercise. This entails refunding all arrears management fees, broken Payment Arrangement fees, unpaid direct debit fees, returned cheque fees and field agent fees and interest on fees charged to customers from January 2009 to January 2016, the automatic refunding of most litigation fees under £750 charged between 1 January 2011 and September 2016 and, where customers have been charged litigation fees of more than £750, a manual review is being carried out (with some limited exceptions) to determine whether any litigation fees were applied unfairly and, if so, to refund those fees. In November 2019, LBG estimated that 509,615 customers have received payments totalling £259.9 million. The FCA acknowledges that the redress provided by LBG extends well beyond the period in which the Authority has identified there were failings, and to customers beyond those known to have been treated unfairly. LBG has estimated that redress payments to customers will total approximately £300 million. In addition, LBG voluntarily suspended charging broken Payment Arrangement fees and arrears management fees for customers. The steps that LBG have taken have gone significantly further than they were legally obliged to take.

(2) The Banks showed a significant level of co-operation with the Authority during its investigation, including promptly and voluntarily commissioning a review into the matters referred to in this Notice, and providing that report and notes of interviews with the Banks' staff to the Authority with privilege waived. The Banks also substantively accepted the findings of the Skilled Person.

(3) The Banks have taken considerable steps to remedy the failings in their systems and controls and dedicated considerable resources to making improvements.

6.22. Having taken into account these aggravating and mitigating factors, the Authority has determined that the Step 2 figure should be reduced by 40%.

6.23. Step 3 is therefore £91,495,480.

Step 4: adjustment for deterrence

6.24. Pursuant to DEPP 6.5A.4G, if the Authority considers the figure arrived at after Step 3 is insufficient to deter the firm who committed the breach, or others, from committing further or similar breaches, then the Authority may increase the penalty.

6.25. The Authority considers that the Step 3 figure of £91,495,480 represents a sufficient deterrent to the Banks and others, and so has not increased the penalty at Step 4.

6.26. Step 4 is therefore £91,495,480.

Step 5: settlement discount

6.27. Pursuant to DEPP 6.5A.5G, if the Authority and the firm on whom a penalty is to be imposed agree the amount of the financial penalty and other terms, DEPP 6.7 provides that the amount of the financial penalty which might otherwise have been payable will be reduced to reflect the stage at which the Authority and the firm reached agreement.

6.28. The Authority and the Banks reached agreement at Stage 1 and so a 30% discount applies to the Step 4 figure.

6.29. Step 5 is therefore £64,046,800. It is the Authority's usual practice to round down the final penalty figure to the nearest £100.

Penalty

6.30. The Authority hereby imposes a total financial penalty of £64,046,800 on the Banks for breaching Principles 3 and 6.

7. REPRESENTATIONS

7.1. Annex B contains a brief summary of the key representations made by the Banks and how they have been dealt with. As the Banks agreed to settle in relation to all relevant facts and all issues as to whether those facts constitute breaches, the

Banks only made representations on the proposed financial penalty. In making the decision which gave rise to the obligation to give this Notice, the Authority has taken into account all of the representations made by the Banks, whether or not set out in Annex B.

8. PROCEDURAL MATTERS

8.1. This Notice is given to the Banks under and in accordance with section 390 of the Act. The following statutory rights are important.

Decision maker

8.2. The decision which gave rise to the obligation to give this Notice was made by the RDC. The RDC is a committee of the Authority which takes certain decisions on behalf of the Authority. The members of the RDC are separate to the Authority staff involved in conducting investigations and recommending action against firms and individuals. Further information about the RDC can be found on the Authority's website:

https://www.fca.org.uk/about/committees/regulatory-decisions-committee-rdc

Manner and time for payment

8.3. The financial penalty must be paid in full by the Banks to the Authority no later than 25 June 2020.

If the financial penalty is not paid

8.4. If all or any of the financial penalty is outstanding on 26 June 2020, the Authority may recover the outstanding amount as a debt owed by the Banks and due to the Authority.

Publicity

8.5. Sections 391(4), 391(6) and 391(7) of the Act apply to the publication of information about the matter to which this notice relates. Under those provisions, the Authority must publish such information about the matter to which this notice relates as the Authority considers appropriate. The information may be published in such manner as the Authority considers appropriate. However, the Authority may not publish information if such publication would, in the opinion of the Authority, be unfair to the recipient of the notice or prejudicial to the interests of consumers or detrimental to the stability of the UK financial system.

8.6. The Authority intends to publish such information about the matter to which this Final Notice relates as it considers appropriate.

Authority contacts

8.7. For more information concerning this matter generally, contact Helena Varney at the Authority (direct line: 020 7066 3666/email: Helena.varney@fca.org.uk).

Anthony Monaghan

Head of Department

Financial Conduct Authority, Enforcement and Market Oversight Division

ANNEX A

RELEVANT STATUTORY AND REGULATORY PROVISIONS

1. Relevant Statutory Provisions

1.1. The Authority's operational objectives are set out in section 1B (3) of the Act and include the objective of securing an appropriate degree of protection for consumers; protecting and enhancing the integrity of the UK financial system; and promoting effective competition in the interests of customers.

1.2. During the Relevant Period until 31 March 2013, section 206(1) of the Act provided:

"If the Authority considers that an authorised person has contravened a requirement imposed on him by or under this Act… it may impose on him a penalty, in respect of the contravention, of such amount as it considers appropriate."

1.3. During the Relevant Period from 1 April 2013 until the end of the Relevant Period on 21 December 2015, section 206(1) of the Act provided:

"If the appropriate regulator considers that an authorised person has contravened a relevant requirement imposed on the person, it may impose on him a penalty, in respect of the contravention, of such amount as it considers appropriate."

2. Relevant Regulatory Provisions

2.1. The various relevant regulatory provisions as they were in force during the Relevant Period are set out below.

Principles for Businesses ("Principles")

2.2. The Principles are a general statement of the fundamental obligations of firms under the regulatory system and are set out in the Authority's Handbook. They derive their authority from the Authority's rule-making powers set out in the Act. The relevant Principles are as follows.

2.3. Principle 3 (management and control) provides that:

"A firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems."

2.4. Principle 6 (customers' interests) provides that:

"A firm must pay due regard to the interest of its customers and treat them fairly."

Mortgages and Home Finance: Conduct of Business sourcebook ("MCOB")

2.5. During the Relevant Period until 26 April 2014, MCOB 13.3.1 R provided:

(1) A firm must deal fairly with any customer who:

(a) is in arrears on a regulated mortgage contract or home purchase plan;

(b) has a sale shortfall; or

(c) is otherwise in breach of a home purchase plan.

(2) A firm must put in place, and operate in accordance with, a written policy (agreed by its respective governing body) and procedures for complying with (1). Such policy and procedures must reflect the requirements of MCOB 13.3.2A R and MCOB 13.3.4A R.

2.6. From 26 April 2014 until the end of the Relevant Period, the wording in MCOB 13.3.1 R(1)(a) provided "has a payment shortfall on a regulated mortgage contract or home purchase plan".

2.7. During the Relevant Period MCOB 13.3.2A R provided:

A firm must, when dealing with any customer in payment difficulties:

(1) make reasonable efforts to reach an agreement with a customer over the method of repaying any payment shortfall or sale shortfall, in the case of the former having regard to the desirability of agreeing with the customer an alternative to taking possession of the property;

(2) liaise, if the customer makes arrangements for this, with a third-party source of advice regarding the payment shortfall or sale shortfall;

(3) allow a reasonable time over which the payment shortfall or sale shortfall should be repaid, having particular regard to the need to establish, where feasible, a payment plan which is practical in terms of the circumstances of the customer;

(4) grant, unless it has good reason not to do so, a customer's request for a change to:

(a) the date on which the payment is due (providing it is within the same payment period); or

(b) the method by which payment is made;

and give the customer a written explanation of its reasons if it refuses the request;

(5) where no reasonable payment arrangement can be made, allow the customer to remain in possession for a reasonable period to effect a sale; and

(6) not repossess the property unless all other reasonable attempts to resolve the position have failed.

2.8. During the Relevant Period until 26 April 2014, MCOB 13.3.4A R provided that:

In complying with MCOB 13.3.2A R(6):

(1) a firm must consider whether, given the individual circumstances of the customer, it is appropriate to do one or more of the following in relation to the regulated mortgage contract or home purchase plan with the agreement of the customer:

(a) extend its term; or

(b) change its type; or

(c) defer payment of interest due on the regulated mortgage contract or of sums due under the home purchase plan (including, in either case, on any sale shortfall); or

(d) treat the payment shortfall as if it was part of the original amount provided (but a firm must not automatically capitalise a payment shortfall); or

(e) make use of any Government forbearance initiatives in which the firm chooses to participate;

(2) a firm must give customers adequate information to understand the implications of any proposed arrangement; one approach may be to provide information on the new terms in line with the annual statement provisions.

2.9. During the Relevant Period from 26 April 2014, the wording in MCOB 13.3.4A R(1)(d) provided "treat the payment shortfall as if it was part of the original amount provided (but a firm must not automatically capitalise a payment shortfall where the impact would be material)".

2.10. During the Relevant Period until 26 April 2014, MCOB 13.3.9 R provided:

(1) A mortgage lender or administrator must make and retain an adequate record of its dealings with a customer whose account is in arrears or who has a sale shortfall, which will enable the firm to show its compliance with this chapter. That record must include a recording of all telephone conversations between the firm and the customer which discuss the sums due.

(2) A mortgage lender or administrator must retain the record required by (1) for three years from the date of the dealing.

The Dispute Resolution: Complaints rules ("DISP")

2.11. DISP 1.3.1R provides:

"Effective and transparent procedures for the reasonable and prompt handling of complaints must be established, implemented and maintained by:

a respondent…"

Decision Procedure and Penalties Manual ("DEPP")

2.12. Chapter 6 of DEPP, which forms part of the Authority's Handbook, sets out the Authority's statement of policy with respect to the imposition and amount of financial penalties under the Act.

The Enforcement Guide

2.13. The Enforcement Guide sets out the Authority's approach to exercising its main enforcement powers under the Act.

2.14. Chapter 7 of the Enforcement Guide sets out the Authority's approach to exercising its power to impose a financial a penalty.

ANNEX B

REPRESENTATIONS

1. The Banks' representations (in italics), and the Authority's conclusions in respect of them, are set out below.

Summary of the Banks' position on penalty

2. *In the Warning Notice, the Authority (through its Enforcement and Market Oversight Division case team) proposed a financial penalty of £51,237,400, calculated as set out below. The Banks dispute some, but not all, elements of this penalty calculation:*

   <u>Step 1: Disgorgement</u>

   - *Step 1 = £0. This is agreed by the Banks.*

   <u>Step 2: Seriousness of the breach</u>

   - *The Step 2 figure should be based on the Banks' relevant revenue, which the case team considers comprises all interest income and fee income (although excluding non-arrears related fees) derived from customers while their accounts were in arrears during the Relevant Period. The case team considers the relevant revenue totals £1,524,924,670. This approach to determining the Step 2 figure is not agreed by the Banks.*
   - *The level of seriousness is level 3. This is agreed by the Banks.*
   - *The case team considers that the resulting Step 2 figure of £152,492,467 is disproportionate and should be reduced by 20% to give an adjusted Step 2 figure of £121,933,973. The Banks agree that a Step 2 figure of £152,492,467 is disproportionate but consider that, if that figure is used, there should be a significantly greater discount for proportionality.*

   <u>Step 3: Aggravating and mitigating factors</u>

   - *The Step 2 figure should be decreased by 40% to reflect relevant aggravating and mitigating factors, to give a Step 3 figure of £73,196,384. The Banks agree that the penalty should be decreased at Step 3, but consider that the Step 2 figure should be reduced by a greater amount.*

<u>Step 4: Adjustment for deterrence</u>

- *No adjustment for deterrence is needed at Step 4, so the Step 4 figure is £73,196,384. The Banks agree that no adjustment is needed at Step 4.*

<u>Step 5: Settlement discount</u>

- *A 30% discount applies as the Authority and the Banks reached agreement at Stage 1, so the Step 5 figure is £51,237,400. The Banks agree that the 30% discount applies.*

3. The Authority acknowledges that this was the approach to calculating the financial penalty proposed in the Warning Notice. As explained in more detail below, the Authority (acting through the RDC), having considered the representations made by the Banks, considers that this remains the appropriate approach to calculating the financial penalty, except in respect of the proportionality discount. The Authority instead determined that the Step 2 figure of £152,492,467 was not disproportionate and that there should therefore be no proportionality discount. Accordingly, as set out in section 6 of this Notice, and after applying all five steps of the penalty policy, the Authority hereby imposes a financial penalty of £64,046,800.

Step 2 – whether relevant revenue is an appropriate metric

4. *In accordance with the relevant guidance in DEPP 6.5A.2G, at Step 2 the Authority must determine a starting figure which is an appropriate indicator of the harm or potential harm that the breach may cause. That means that the starting figure must be a good proxy for the harm or potential harm caused by the Banks' breaches. However, in this case, revenue is not an appropriate metric for determining the penalty as it is not an indicator of the harm or potential harm caused by the Banks' breaches.*

5. *The fundamental defect of the revenue figure adopted in the Warning Notice is that by far the greater part of it (interest on capital) is unrelated to the breaches in question or to the potential, let alone actual, harm flowing from those breaches. The Banks' mortgage revenue from accounts in arrears comprises interest revenue and fee revenue. Interest revenue is subdivided into interest on capital paid whilst accounts are in arrears (accounting for 96% of interest revenue) and interest on arrears (4%). Fee revenue comprises non-arrears related fees (93.7%, including from accounts not in arrears) and*

arrears-related fees (6.3%). Interest revenue comprises 93.9% of the total revenue used in the Warning Notice penalty calculation, with arrears-related fee revenue comprising the other 6.1%. Interest on capital therefore comprises approximately 90.2% of the total relevant revenue used in the Warning Notice penalty calculation. The obligation to pay interest on capital is unaffected by the breaches, as it arises whether or not customers fall into arrears and regardless of the fairness or otherwise of the treatment of customers when in arrears. As customers would therefore have paid this interest on capital even if there had been no breaches, and as it is by far the largest constituent element of the case team's revenue figure, it is inappropriate to use revenue as the starting figure.

6. *Although there might be the occasional circumstance in which interest on capital is inherently linked to the unfair treatment of customers in arrears, and thus to the (potential) harm caused by the breaches - for example, customers who as a result of unfair treatment by the Banks might have missed the opportunity voluntarily to surrender their property - such situations are so few and minor as to be materially insignificant.*

7. *The proposed approach in this case can be contrasted with that taken in other comparable cases where a substantial penalty has been imposed on a relevant revenue basis (namely the financial penalties imposed by the Authority on Standard Chartered Bank in February 2019, on Deutsche Bank AG in January 2017 and on Standard Life Assurance Ltd in July 2019). In each of those cases, there is at least a close link between the (potential) harm caused by the breaches and the relevant revenue figure adopted.*

8. *It is notable that the case team's calculation of the relevant revenue does not include non-arrears related fees, which amount to 93.7% of the Banks' fee revenue and consist of origination fees (those incurred at the commencement of a mortgage) and non-origination fees (other fees incurred during the course of the mortgage term but which are not related to arrears). Just like interest on capital, these fees have no material connection to the (potential) harm caused by the breaches, and thus are rightly excluded. That logic should extend to interest on capital.*

9. *Whilst the approach adopted by the case team follows that used in calculating the financial penalty imposed by the Authority on Yorkshire Building Society*

(YBS) in October 2014 for similar mortgage arrears handling failings, that is not a persuasive reason to use the same approach here. That was a settled case and so it does not appear that there was any argument directed to this issue. YBS also had a much smaller mortgage book and the duration of its breaches was much shorter, being less than a year, so the inappropriateness of adopting relevant revenue as the starting point may have been less apparent and the consequences of doing so may have been less significant.

10. *The existence of the YBS final notice does not preclude the Authority from adopting an alternative metric for harm now. There have been previous cases where different metrics have been used despite the misconduct being similar.*

11. *In addition, whilst there are a number of factual similarities between the Banks' breaches and those of YBS, there are also a number of points of distinction:*

    a. *The level of unfair customer outcomes identified by the skilled person in the YBS case was far higher than the level identified by the Skilled Person in this case. The breaches only relate to the subset of the Banks' mortgage customers who fell into arrears during the Relevant Period (approximately 1.5 – 2.5% of all mortgage customers), and there is no evidence to indicate that any more than a minority of those customers were in fact treated unfairly.*
    b. *YBS made deliberate decisions not to follow the Authority's guidance on good practice on the handling of customers in mortgage arrears, whereas the Authority accepts that the Banks' breaches were committed inadvertently.*
    c. *YBS did not identify its breaches itself and instead they were brought to its attention by the Authority. In contrast, the Banks conducted an internal review of mortgage forbearance activities in April 2011 and so had a level of awareness of the issues throughout the Relevant Period.*

12. Step 2 of the Authority's penalty policy for firms, as set out in DEPP 6.5A.2G, requires the Authority to determine a figure that reflects the seriousness of the breach. In this case, it was agreed that the Banks' breaches are of seriousness level 3. The breaches involve failings in the Banks' systems and controls for mortgage arrears handling over a period of four years and eight months, and are serious because: (i) there was a significant risk of loss to

individual customers who were in arrears during the Relevant Period; and (ii) there were systemic weaknesses in the Banks' internal systems and controls relating to making Payment Arrangements with customers in mortgage arrears.

13. Pursuant to DEPP 6.5A.2G(1) and (2), where the amount of revenue generated by a firm from a particular product or business area is indicative of the harm or potential harm that its breach may cause, the Authority will determine a figure at Step 2 which will be based on a percentage of the firm's relevant revenue. The firm's relevant revenue will be the revenue derived by the firm during the period of the breach from the products or business areas to which the breach relates.

14. The harm or potential harm caused by the Banks' systems and controls failings was that the Banks' mortgage customers were at risk of being treated unfairly, in particular those in arrears, a substantial proportion of whom were likely to be vulnerable. Specifically, there was a risk that the inappropriate treatment of customers in arrears could have caused individual customers to incur fees and/or remain in arrears for longer than necessary.

15. The Banks earned revenue from their mortgage customers who were at risk of being treated unfairly as a result of the Banks' breaches. The more customers that went into arrears, and the longer that customers stayed in arrears, the greater the potential risk of harm to the Banks' customers and the higher the amount of revenue that the Banks would have earned. As a result, the Authority considers there is a clear connection between the Banks' failings and their revenue. The Authority has therefore concluded that the revenue generated by the Banks from their mortgage customers who were exposed to the risk of being treated unfairly is indicative of the harm or potential harm caused by the breaches. It has therefore decided that it is appropriate to base the Step 2 figure on the Banks' relevant revenue.

16. In accordance with the Authority's penalty policy, the Banks' relevant revenue should consist of the revenue derived by the Banks from the relevant products or business areas during the Relevant Period. In this case, although the Authority considers it could be argued that *all* of the Banks' mortgage customers were at risk of being treated unfairly, as they could all potentially have gone into arrears, it was only those customers actually in arrears who

were materially at risk. The Authority has therefore concluded it is appropriate for the relevant revenue to consist of the revenue derived by the Banks from their mortgage customers in arrears, while their accounts were in arrears, during the Relevant Period.

17. There is no requirement in the penalty policy for there to be a causal link between each element of relevant revenue and the breaches. Instead, provided a payment was received by the Banks from the products or business areas to which the breaches relate (i.e. from the product 'mortgages in arrears' or the business area of mortgage arrears handling), then that payment falls within the definition of relevant revenue in DEPP 6.5A.2G(2). Accordingly, the Banks' relevant revenue consists of all the fees and interest they received during the Relevant Period from mortgage customers whose accounts were in arrears, while they were in arrears, including interest on capital. This is the case irrespective of whether the breaches had an impact on the contractual obligation on the customer to pay interest on the capital borrowed.

18. In any event, interest on capital is inherently linked to the mortgage product and the unfair treatment of a customer in arrears. If customers in arrears are treated inappropriately, there is a real risk that they would incur fees and/or pay interest on capital that the bank would not have received if the customer had been treated fairly. For example, if a customer's financial circumstances fundamentally changed, such that the house they owned became unaffordable, it might be appropriate for them to sell the house and buy or rent a more affordable property. In that case, if their circumstances were adequately assessed, and it was determined that exiting the mortgage was the appropriate course of action, the bank would cease to generate income from the total amount, including interest on capital, rather than just from the arrears balance. However, if the customer was not treated fairly, there would be a risk that they would not exit the mortgage and instead would continue paying interest on capital. A decision by a customer to sell their property is a more realistic scenario than a customer deciding to voluntarily surrender their property, and the Authority does not accept that such situations are so minor and unlikely that they can properly be ignored.

19. The Authority does not consider that the use of relevant revenue in other cases where a substantial financial penalty has been imposed, and where there is a close link between the (potential) harm caused by the breaches and the

relevant revenue figure adopted, is a reason not to adopt relevant revenue in this case. The Authority considers there is a connection between the harm caused by the breaches and the Banks' relevant revenue and that it is appropriate to use relevant revenue to determine the Step 2 figure in this case for the reasons set out above.

20. The Authority excluded non-arrears related fees from the relevant revenue figure for pragmatic reasons relating to the logistics of obtaining the relevant information. The Banks advised the Authority during the investigation that they were unable to identify which of these fees were incurred whilst accounts were in arrears without conducting a review of each account to ascertain the time periods for which the accounts were in arrears, and the Authority, in the understanding that the amount of such fees would not make a material difference to the total revenue figure, decided it was not reasonable or practicable to impose such an onerous requirement. Taking this approach therefore means that the calculation of the financial penalty is actually slightly generous to the Banks, but it does not mean that interest on capital should also be excluded.

21. In October 2014, the Authority imposed a financial penalty on YBS for failings in relation to its handling of mortgage customers in payment difficulties or arrears. This financial penalty was based on YBS's relevant revenue, which consisted of the total level of fees (including non-arrears related fees) and interest payments (including interest on capital) received from customers while their accounts were in arrears during the period of YBS's breaches. For the reasons set out above, the Authority considers it is appropriate to use relevant revenue in this case and that it is therefore not appropriate to deviate from the approach taken in the YBS case (other than to exclude non-arrears related fees, for the reasons given in the above paragraph). Further, unless there is a good reason not to, it is appropriate to take a consistent approach to calculating penalty for similar breaches, and so the approach used in the YBS case is a helpful precedent for deciding on the approach to penalty in this case. The factual points of distinction between the cases identified by the Banks are relevant to seriousness or, in respect of the awareness of the breaches, are potentially aggravating or mitigating factors, but do not justify the adoption of a different methodology where the misconduct is sufficiently similar.

Step 2 – alternative metric

22. *DEPP 6.5A.2G allows for the Authority to use an alternative metric where revenue is not appropriate, and the Authority has done so in many previous cases. In this case, rather than use revenue, the appropriate approach is to use an alternative metric that comprises the total of arrears-related fees and the interest on arrears balances, as this most meaningfully reflects the actual and potential customer detriment.*

23. *Adopting this alternative approach would result in a substantial starting figure of approximately £150 million, which is a far more appropriate starting figure to reflect seriousness than the approximately £1.5 billion figure contained in the Warning Notice. Taking 10% of that figure (as this is a level 3 seriousness case) results in a Step 2 figure of approximately £15 million. The Banks consider that level of penalty is appropriate for the breaches concerned and a sufficient deterrent. However, should that figure not be considered a credible deterrent, that does not mean this approach is wrong. Instead, if necessary, the penalty could be increased at Step 4, which is the step in the penalty calculation process where deterrence is considered. Deterrence should not be used as a reason for adopting a Step 2 starting figure which is not indicative of harm.*

24. *Furthermore, and crucially in relation to deterrence, the generous redress scheme instituted by the Banks to put right the (potential) harm caused to customers will result in the Banks paying remediation to customers of approximately £300 million. On top of that, the costs of administering the comprehensive remediation process are estimated to amount to approximately £167 million. Therefore, the estimated total cost to the Banks flowing from the agreed breaches is approximately £470 million, even before the significant costs of the changes the Banks have made to improve the treatment of customers in financial difficulty and the costs of the Skilled Person's Review and the Authority's investigation are taken into account. There is therefore already the strongest possible monetary incentive, for both the Banks and other firms, to ensure that their systems and controls can never again permit such breaches to occur.*

25. As the Authority considers that relevant revenue is an appropriate indicator of harm or potential harm, it is not necessary for the Authority to identify an alternative proxy for harm. In accordance with DEPP, the Authority only

considers possible alternative metrics where revenue is not an appropriate indicator.

26. DEPP 6.5A.2G(1) makes it clear that the amount of relevant revenue is relevant in terms of the size of the financial penalty necessary to act as a credible deterrent. Accordingly, credible deterrence is not only considered at Step 4 of the penalty policy; it is also relevant at Step 2. The Authority considers that a significant financial penalty is required at Step 2 in order to provide a credible economic incentive to the Banks and to other firms to prioritise putting in place appropriate systems, controls and arrangements for oversight which ensure fairness to customers and minimise the risk of harm being caused to customers.

27. The Banks' alternative penalty calculations result in penalty figures that are too low to be a credible deterrent to either the Banks or the mortgage market, especially taking into account the facts that the Banks' regulated mortgage book balance was £233 billion in December 2015, with an arrears balance of £285 million, and that approximately 367,000 individual customers were in arrears at some point during the Relevant Period. In contrast, using the Banks' relevant revenue as the basis for calculating the Step 2 figure means that there is no need for a credible deterrence uplift at Step 4.

28. Further, the amount of redress paid by the Banks, which the Banks informed the Authority amounted to £145.5 million in respect of the breaches which occurred during the Relevant Period, and the Banks' overall remediation costs, also indicate both the scale of the concerns set out in this Notice and that a financial penalty of the size proposed by the Banks would not be an effective deterrent. The Authority considers that the administrative costs of remediation are unlikely to be a deterrent, as to an extent these reflect the fact that the Banks failed to invest sufficiently in putting in place appropriate systems and controls to ensure that the breaches did not occur in the first place.

Step 2 – how to calculate relevant revenue

29. *As mentioned above, the Banks consider that revenue is not the appropriate metric for determining the penalty. However, if the RDC determines that it is, those elements of revenue that are not relevant to the breach should be*

excluded to ensure that the starting point of the Step 2 calculation is truly reflective of the harm caused or potentially caused by the Banks' breaches.

30. *It is possible for the Authority to treat parts only of revenue as relevant revenue. This flexibility is demonstrated by the case team's calculation of relevant revenue, which is confined to revenue derived from mortgage accounts in arrears rather than all mortgage accounts from the relevant business area, and then excludes non-arrears related fees from that revenue.*

31. *As well as non-arrears related fees, interest on capital should be excluded for the reasons given in paragraph 5 above. This would have the merit of consistency as it would mean that the two areas of revenue (non-arrears related fees and interest on capital) which are unrelated to the harm or potential harm would be excluded, while the two areas of revenue (arrears-related fees and interest on arrears) which do bear a potential relation to the harm caused by the breaches would be retained. That would result in the same starting figure and Step 2 figure as those mentioned in paragraph 23 above.*

32. *Further, should the RDC reject the Banks' submission that interest on capital should be excluded, the Banks submit that interest on capital should only be considered net of the Banks' costs of funding the mortgages in question. This is because:*

    a. *It is industry standard, reflecting usual accounting practice, for banks to net off cost of funding from interest they receive when stating revenue figures in financial statements. This is the Banks' usual practice, as can be seen from LBG's consolidated income statement in its Annual Report and Accounts 2019;*
    b. *The cost of funding is a fundamental part of being able to advance mortgage loans and therefore should be distinguished from normal operating or other typical costs which might be deducted from relevant revenue; and*
    c. *As the cost of funding is incurred by the Banks regardless of their treatment of customers in arrears, or indeed regardless of whether customers fall into arrears at all, it can have no connection with the Banks' breaches or the harm or potential harm caused to a customer.*

33. *Using a relevant revenue figure which includes interest on capital net of the Banks' costs of funding would result in a starting figure of approximately £543 million and a Step 2 figure of approximately £54.3 million.*

34. The Authority accepts that its penalty policy allows some flexibility in determining relevant revenue, and that it has acted flexibly in this case by confining the relevant revenue to that derived by the Banks from customers' mortgage accounts in arrears and by excluding non-arrears related fees from that revenue. However, for the reasons given in paragraphs 17 and 18 above, the Authority considers that it is not appropriate to exclude interest on capital from the relevant revenue calculation.

35. The Authority also considers it would not be appropriate for the interest on capital figure to be net of the cost of funding. In order to comply with international accounting standards, the Banks, where they are acting as principal in lending transactions, are obliged to include within the consolidated income statement in their audited financial statements interest and similar income stated gross. They then disclose interest and similar expense to arrive at a figure for net interest income. The Authority considers the Banks' relevant revenue to be the revenue derived from their mortgage customers in arrears. Interest comprises the largest component of such revenue and is paid gross by the customer, not net. Since customers have no control over how the bank decides to source funding, and international accounting standards require disclosure of interest revenue gross where a lender is acting as principal rather than agent, the Authority considers it would be inappropriate to regard net interest as a measure of relevant income when assessing harm or potential harm to a customer. The Authority considers net interest to be more akin to gross profit, use of which as a measure of relevant revenue would not be in accordance with the Authority's penalty policy.

36. The fact that relevant revenue should not be net of certain costs is illustrated by the Tribunal's decision in April 2019 regarding the appropriateness of a financial penalty that the Authority had decided to impose on Linear Investments Limited. The Tribunal was not persuaded by Linear Investments Limited's argument that, if revenue was to be used, it should be net revenue rather than gross revenue, stating: "*to embark on an exercise of departing from gross revenue on the basis of a particular firm's business model would involve*

complexities that would effectively destroy the usefulness of adopting revenue as a starting point".

Step 2 - proportionality

37. *If the case team's approach to relevant revenue is deemed by the RDC to be correct, the resulting Step 2 figure of £152,492,467 is disproportionate. The case team accepts this and proposes that it should be reduced by 20% to result in an adjusted Step 2 figure of £121,933,973. The Banks consider that the adjustment for proportionality should be significantly greater to better reflect the nature and seriousness of the breaches, the actual or potential harm caused, and to bring the overall penalty closer to the penalty imposed on YBS for similar breaches, which was calculated as £4,726,489 at Step 2.*

38. *Proportionality discounts act as a sense-check for the penalty as a whole. In order for that sense-check to be meaningful, proportionality should be assessed not just by reference to the overall number, but also by reference to the breaches in question and the harm caused. In this case, should the case team's relevant revenue figure be used despite the fact that it does not reflect the actual or potential harm caused to customers, it follows that a substantial reduction at Step 2 is necessary to provide a proportionate penalty which more closely relates to the harm (actual and potential) caused by the breaches.*

39. *The Authority's approach to applying a proportionality discount in previous cases, where the breaches in question were assessed by the Authority as more serious or the same level of seriousness as the Banks' breaches, supports the Banks' submission that a much larger proportionality discount is appropriate here. For example:*

    a. *The financial penalty imposed on Standard Chartered Bank in February 2019 for breaches of the Money Laundering Regulations, which were stated to be of a nature which could undermine the integrity and stability of the UK's financial markets and institutions and which were assessed as seriousness level 4, involved a 60% reduction of the penalty at Step 2, from approximately £176 million to approximately £70 million;*
    b. *The financial penalty imposed on Deutsche Bank AG in January 2017 for breaches of Principle 3 and specified SYSC rules, which concerned inadequate systems for the prevention of financial crime and which*

were assessed as seriousness level 4, involved a proportionality discount of approximately 90%, so that the Step 2 figure was reduced from approximately £1.7 billion to £200 million;

c. *The financial penalty imposed on the Prudential Assurance Company Ltd in September 2019 for breaches of Principles 3 and 6 which occurred after the current penalty policy came into force, which concerned the mis-selling of annuities to pension customers and which were assessed as seriousness level 3, involved a proportionality discount of 95%, so that the Step 2 figure was reduced from approximately £600 million to approximately £30 million; and*

d. *The financial penalty imposed on Standard Life Assurance Limited in July 2019 for breaches of Principles 3 and 6 which occurred after the current penalty policy came into force, which concerned the mis-selling of annuities to pension customers and which were assessed as seriousness level 4, involved a proportionality discount of 75%, so that the Step 2 figure was reduced from approximately £177 million to approximately £44 million.*

40. *There are precedents for the Authority reducing the penalty imposed on a larger firm on the basis of disproportionality and so bringing the proposed penalty nearer to that imposed on a smaller firm for the same type of breach. In particular, the financial penalty imposed on Rio Tinto Plc in October 2017 for breaches of the Disclosure and Transparency Rules involved a 25% discount for proportionality, so that the Step 2 figure was reduced from approximately £52 million to approximately £39 million. Rio Tinto Plc's breaches were similar to those by Lamprell Plc which led to a financial penalty of approximately £2.5 million being imposed on Lamprell Plc in March 2013. That penalty was much smaller than Rio Tinto's as a result of Lamprell's much smaller market capitalisation (which was the alternative metric used in both of those cases), even though the seriousness level of Lamprell's breaches was much higher (level 4 compared to level 2), and so the discount brought the penalties closer in line. A similar logic should apply here to bring the overall penalty closer to that imposed on YBS for similar breaches. The Step 2 figure in the Warning Notice is out of step with the financial penalty imposed on YBS in a way which places too much weight on the Banks' size, even with a 20% discount applied, so an additional discount for proportionality should be applied to rectify such a disparity.*

41. *In deciding on the level of proportionality discount, the Authority should take into account not only the potential harm, but the likelihood of actual harm. In particular, having regard to the Skilled Person's findings, there is no evidence to support any inference that more than a minority of the Banks' customers in arrears are likely to have been treated unfairly.*

42. The Authority agrees that a proportionality assessment acts as a sense-check for the penalty as a whole, and that any adjustments should be considered on a case-by-case basis. The Authority (through the RDC) has had regard to the case team's view that a 20% proportionality reduction is appropriate, and to the Banks' view that a much larger reduction is needed, but has concluded that the Step 2 figure of £152,492,467 is not disproportionate and that a proportionality discount is therefore not warranted.

43. In reaching this conclusion, the Authority has had particular regard to the following matters: the nature and seriousness of the Banks' breaches and the risk of harm or potential harm caused by them; the approach taken by the Authority in previous cases; the fact that the Authority has tailored the relevant revenue figure by limiting the revenue to that derived from customers' mortgage accounts in arrears, whilst they were in arrears; the relative size of the YBS penalty; and the reason given by the case team for recommending that the Step 2 figure should be reduced by 20% for proportionality reasons.

44. The Authority and the Banks agree that the breaches are of seriousness level 3. They took place over a long period of time and involved a significant risk of loss to individual customers in arrears, a substantial proportion of whom were likely to have been vulnerable. LBG (of which the Banks are subsidiary legal entities) was the largest mortgage provider in the UK throughout the Relevant Period, and the size of the Banks' regulated mortgage book and the large number of customers who were in arrears during the Relevant Period support the conclusion that there was a widespread risk of harm. The Skilled Person identified that 38% of the customers whose files it reviewed had been unfairly treated. Whilst recognising that this was a non-statistical sample and that there is a degree of uncertainty as to the extent of the customer detriment that can be drawn from it, the Authority considers this indicates that a significant proportion of customers are likely to have been treated unfairly. Therefore, taking into account all of these matters, the Authority considers that, whilst not the most egregious misconduct, the breaches were serious and deserving of a

substantial financial penalty, and that there is no obvious basis for concluding that, due to the nature and seriousness of the breaches, a financial penalty of approximately £150 million is disproportionate.

45. Whilst each penalty calculation turns on the consideration of the individual facts of the case, the Authority considers that it can be helpful in considering the proportionality of a proposed penalty to have regard to the approach taken in previous cases. The Authority has therefore had careful regard to the previous cases referenced by the Banks where a proportionality discount was applied.

46. The Authority notes that in the Standard Chartered Bank and Deutsche Bank cases, the relevant revenue extended across a broad spectrum of the firms' business areas, which led the Authority to conclude that a proportionality discount was warranted. Had the Step 2 figure in this case been based on the revenue derived by the Banks from *all* of their retail mortgage customers, the Authority considers that a similar approach would have been justified. However, the Authority has already tailored the relevant revenue figure by limiting the revenue to that derived from customers' mortgage accounts in arrears, whilst they were in arrears. The Authority also notes that there appears to have been no tailoring of the relevant revenue figure in the Prudential Assurance or Standard Life Assurance cases. The Step 2 figure in the Prudential Assurance case was far higher than that in this case, whilst in the Standard Life Assurance case, the number of customers potentially affected was far fewer than in this case and the total redress expected to be paid out was far lower. The Authority therefore concludes that the approach taken in these previous cases does not clearly support the Banks' submission that the Step 2 figure is disproportionate.

47. Further, the Authority notes that reductions for proportionality reasons are exceptional and that there have been a number of previous cases where the Step 2 figure has been of a substantial size but no proportionality discount has been applied. For example, the financial penalty imposed on LBG in June 2015 for failings in relation to its handling of PPI complaints involved a Step 2 figure of nearly £130 million. The Authority notes that LBG's misconduct in that case was assessed as seriousness level 3, the same level of seriousness as the Banks' misconduct in this case. Although the Authority is wary of drawing meaningful conclusions from the approach taken in previous cases where the failings were of a different nature to those in this case, the Authority nevertheless considers that the lack of a proportionality discount in that case indicates that, whilst the

breaches in this case might not be as serious as some of the cases in which the financial penalty has been reduced at Step 2, this does not mean that a financial penalty of approximately £150 million is necessarily disproportionate.

48. In contrast to the previous cases mentioned above, the Authority considers that the financial penalty imposed on YBS for similar misconduct is more helpful in considering the proportionality of the Step 2 figure in this case. The Authority has carefully compared the two cases and notes that: the period of YBS's misconduct was much shorter (10 months as against 56 months); the amount of redress provided by YBS was far smaller (£8.4 million as against approximately £300 million)[i]; the number of customers who had mortgages in arrears during the relevant period and were therefore potentially affected by the misconduct was far fewer in YBS's case (9,000[ii] as against 367,000)[iii]; and the size of YBS's mortgage book was much smaller (£28.3 billion as against £223 billion). YBS's relevant revenue (calculated in a similar way to the Banks' relevant revenue but over a period of 12 months rather than the period of the breach) was also far less (approximately £47 million as against approximately £1.5 billion), which is reflective in particular of the differences in the number of customers affected and the length of the relevant period. The Authority considers that these figures demonstrate that it is appropriate and necessary to impose a far higher financial penalty on the Banks than on YBS, and that the size of the YBS penalty for similar misconduct does not indicate that the Step 2 figure of approximately £150 million is disproportionate.

49. The case team recommended that the Step 2 figure be reduced by 20% for proportionality reasons on the basis that, due to limitations in respect of the relevant evidence, it is difficult to quantify precisely the harm and potential

[i] In both cases, the redress exercise extended beyond the relevant period. The Banks informed the Authority that £145.5 million of the redress provided was in respect of the failings which occurred during the Relevant Period. The Authority (the RDC) does not have an equivalent figure in respect of the redress provided by YBS. As the redress figures mentioned in this paragraph are not restricted to the failings in the relevant periods, the Authority considers they have only limited relevance in considering proportionality.

[ii] According to paragraph 4.17 of the YBS final notice, this was the number of customers that YBS dealt with during the relevant period whose accounts were in arrears by more than two months.

[iii] The respective number of customers who were expected to receive redress were approximately 33,900 customers of YBS and approximately 526,000 customers of the Banks. These higher figures reflect the fact that the redress exercise in both cases extended beyond the relevant period. The Authority considers it to be more helpful to compare the actual number of customers in arrears during the relevant periods, and therefore at risk of being treated unfairly.

harm caused by the Banks' breaches. As mentioned in paragraph 44 above, the Authority recognises that there is a degree of uncertainty as to the extent of the actual customer detriment that can be drawn from the Skilled Person's findings, but considers they indicate that a significant proportion of customers are likely to have been treated unfairly. Whilst it is possible that the actual proportion might have been fewer than 38% of customers, it is also possible that the proportion might have been higher. In any case, even if the Banks are given the benefit of the doubt on the level of actual harm caused, as the financial penalty is being imposed on the Banks because their breaches of Principles 3 and 6 caused a significant *risk of harm* to customers in arrears, and as the Authority has concluded that it is appropriate to calculate the penalty by reference to the Banks' relevant revenue because it is an appropriate indicator of the harm *or potential harm* caused by their misconduct, the Authority considers that it would not be appropriate to reduce the financial penalty on the basis that there is limited evidence as to the extent to which the risk of harm actually crystallised. The Authority therefore concludes that some uncertainty regarding the actual level of customer detriment caused by the Banks' breaches is not a sufficient reason to conclude that a reduction to the Step 2 figure is required.

50. Having taken into account all of these matters, the Authority has concluded that the Step 2 figure of £152,492,467 is not obviously disproportionate and so has decided that it is not appropriate to reduce the penalty for disproportionality reasons at Step 2.

Step 3 – mitigating and aggravating factors

51. *The case team proposes a 40% reduction to the penalty at Step 3 and has clarified that this figure was reached by allocating a 60% reduction for mitigating factors and a 20% uplift for aggravating factors. The Banks agree that it is appropriate to apply a substantial reduction of 60% for the mitigating factors mentioned in paragraph 6.22 of this Notice, but do not agree that the two aggravating factors mentioned in paragraph 6.21 of this Notice significantly exacerbate the breaches. The Banks submit that little or no uplift should be applied for those factors and that the overall discount applied at Step 3 should be higher than the 40% proposed by the case team.*

52. *The first aggravating factor is the final notices previously issued to the Banks. These are not relevant to the issues identified in the Warning Notice and*

therefore, in the interests of fairness, should be excluded as aggravating factors. As is mentioned in paragraph 6.21(1) of this Notice, none of these final notices concern similar failings to those identified in this case. Some pertain to entirely unrelated areas of the Banks' businesses or are very old.

53. *Whilst the Banks recognise that a firm's disciplinary history may have relevance as an aggravating factor where it indicates widespread weaknesses in the firm generally, that reasoning is not applicable here. As is mentioned in paragraph 6.16(3) of this Notice, there is no evidence that the breaches indicate a widespread problem or weaknesses in the Banks beyond their systems and controls used by collections and recoveries in respect of Payment Arrangements with customers who are in arrears.*

54. *Taking account of the prior final notices would also effectively and unfairly penalise the Banks based on their size. Banks of the scale and complexity of the Banks are obviously more likely than a bank with smaller and/or fewer businesses, and fewer employees, to experience regulatory issues in their operations. The Banks accept that there is no acceptable or reasonable level of misconduct, but consider that in assessing the level of aggravation represented by a previous disciplinary history, the size of the banking group is relevant.*

55. *The second aggravating factor is prior publications by the Authority, namely guidance on arrears handling and the YBS final notice published in October 2014. The Banks took steps to respond to these publications and so these aggravating factors should be disregarded.*

56. *The Banks took the following steps during the Relevant Period to understand and comply with relevant guidance issued by the Authority:*

    a. *In 2008, the Authority published a guide to good and poor practices in mortgage arrears handling and sent a Dear CEO letter to mortgage providers. The Banks responded by making their businesses more customer-centric, including by making sure they reflected best practice on Treating Customers Fairly.*
    b. *In 2011, the Authority published guidance on forbearance and impairment provisions. The Banks responded by carrying out a gap analysis, which set out 47 actions and observations required to ensure*

that the Banks were complying with good practice, and then launched a pilot programme in response to that gap analysis.

c. *From January 2014 onwards, the Banks implemented a programme of work in response to feedback received following the 2013 Thematic Review and provided the Authority with regular updates regarding the progress made.*

57. *Although there were times during the Relevant Period when progress was slower than senior management of the Banks would have liked, the Banks took these actions seriously and the changes that were introduced resulted in improvements to the treatment of customers in mortgage arrears.*

58. *The YBS final notice was issued towards the end of the Relevant Period, at a time when the Banks were already undertaking a programme of work in response to the Authority's feedback. Upon publication of the YBS final notice, a gap analysis was carried out of the Authority's findings in that case against the Banks' current practices, and the results were presented to the steering group overseeing the actions taken by the Banks in response to the Authority's feedback. There was therefore little if anything more that the Banks could have done during the Relevant Period in response to the YBS decision.*

59. The Authority considers that the substantial 60% discount for the mitigating factors proposed by the case team, and agreed by the Banks, is justified given in particular the scale and extent of the redress scheme, which went significantly beyond the Banks' legal and regulatory obligations.

60. The Authority does not agree with the Banks' submission that the aggravating factors identified at paragraph 6.21 of this Notice do not exacerbate the breaches and that little or no uplift should be applied for these factors. Instead, the Authority considers that a 20% uplift for aggravating factors is appropriate, and that the penalty should therefore be reduced by 40% at Step 3.

61. In respect of the Banks' disciplinary history, whilst acknowledging that previous action was taken for failings in other areas of the Banks' businesses, the Authority considers it is relevant that most other final notices given to the Banks also involve breaches of Principles 3 and/or 6, and that there are common features of failures to have in place appropriate management oversight and

appropriate systems to ensure proper conduct and that customers are treated fairly.

62. The Authority does not agree that the prior final notices should carry less weight because it is more likely that the Banks would have regulatory deficiencies, given the scale and complexity of LBG. Instead, in a large and complex group of banks, there is a particular need for effective management oversight and systems and controls, whereas they may not need to be as sophisticated in a smaller firm. A large banking entity is also likely to have more resources available to devote to compliance. If large banks regularly commit breaches of Principles 3 and 6 it is likely to mean that as an organisation they fail to give sufficient priority to the importance of oversight, controls and ensuring fairness to customers.

63. The Authority acknowledges that the Banks took some steps in response to the Authority's publications, but considers that overall they were not adequate, in particular because they did not promptly stop the breaches set out in this Notice. In respect of the YBS notice, the Authority notes that it was published over a year prior to the end of the Relevant Period, and the Authority considers that the Banks could therefore have learnt the appropriate lessons from that notice and resolved the gaps it identified more quickly.

64. The Authority considers that a 20% uplift for aggravating factors is also in line with that applied by the Authority in other final notices where financial penalties have been imposed on banks, including: the final notice for Deutsche Bank in January 2017; the final notice for UBS in March 2019; the final notice for LBG firms in June 2015; the final notice for Barclays Bank in May 2015; and the final notice for Canara Bank in June 2018.