
FINAL NOTICE

To: Bank of Scotland plc

FSA Reference Number: 169628

Address: The Mound
Edinburgh
EH1 1YZ

Date: 19 October 2012

ACTION

1. For the reasons given in this notice, the FSA imposes on Bank of Scotland plc (BOS) a financial penalty of £4.2 million.
2. BOS agreed to settle at an early stage of the FSA's investigation. It therefore qualified for a 30% (Stage 1) discount pursuant to the FSA's executive settlement procedures. Were it not for this discount, the FSA would have imposed a financial penalty of £6 million on BOS.

SUMMARY OF REASONS

3. The FSA has decided to take this action because BOS breached Principle 3 in that:
 - (1) it relied upon incorrect records held on BOS mortgage systems for considerable periods of time between 2004 and 2011 which resulted in Halifax mortgage customers not receiving important information about changes to the Terms and Conditions of their mortgages; and

(2) as a consequence it failed to implement correctly a programme under the terms of a Voluntary Variation of Permission (VVOP) agreed in February 2011. Under the VVOP the permission for BOS was varied to require it to establish and operate a programme and make goodwill payments to Halifax mortgage customers in recognition that they may have received insufficiently clear information regarding changes to the Terms and Conditions of their mortgages (the Programme).

4. The breaches by BOS are serious for the reasons outlined below:

(1) BOS failed to identify errors that led to inaccurate information being held on its mortgage systems. These errors were only identified after customer complaints were made regarding the implementation of the Programme. This meant that, when the Programme was implemented in 2011, BOS held incorrect records on its systems for up to approximately 250,000 Halifax mortgage customers;

(2) the incorrect records held on BOS mortgage systems meant that around 15% of the 250,000 affected Halifax mortgage customers did not receive important information regarding variations to their mortgages. Consequently these customers were not in a position to make sufficiently informed decisions about their mortgage accounts; and

(3) the 250,000 Halifax mortgage customers were not identified as falling within the Programme and approximately 160,000 of these 250,000 customers were due goodwill payments under the Programme totalling approximately £162 million. These payments may not have been received by them had the complaints from some of those customers not led to the identification of errors in the information held on BOS mortgage systems.

5. Even after taking account of mitigating factors, the conduct of BOS merits the imposition of a substantial financial penalty.

DEFINITIONS

6. The definitions below are used in this Final Notice:
- (1) “the Act” means the Financial Services and Markets Act 2000
 - (2) “the FSA” means the Financial Services Authority
 - (3) “BOS” means Bank of Scotland plc
 - (4) “HBOS” means HBOS Plc
 - (5) “SVR” means Standard Variable Rate
 - (6) “FAD” means Further Advances
 - (7) “PT” means Product Transfer
 - (8) “TOMP” means Transfer of Mortgaged Property
 - (9) “Borrowers” means the BOS mortgage account administration system
 - (10) “CSF” means the BOS mortgage offer document production system

FACTS AND MATTERS

7. The statutory and regulatory provisions relevant to this notice are set out in Annex A.

Background

8. The businesses of Halifax plc and BOS were merged in 2001 and a holding company, HBOS, was created. The business of Halifax plc was transferred to BOS on 17 September 2007. HBOS became part of Lloyds Banking Group through an acquisition by Lloyds TSB Bank Plc in 2009. BOS operates the Bank of Scotland and Halifax brands in the UK.
9. BOS’s revenue is earned through interest and fees on a broad range of financial services products, including mortgages in the retail market. The matters in this Notice relate to the mortgage business written in the UK by BOS under the Halifax brand between 2001 and 2008.

Halifax Standard Variable Rate and Cap

10. The Halifax Standard Variable Rate (SVR) is the interest rate charged on most (but not all) Halifax mortgages entered into prior to 4 January 2011 which are not subject to fixed, tracker or discounted interest rates (which are known as product rates). The SVR is determined by BOS and variation of the rate is at its discretion subject to the variation being for one of the valid reasons listed in the mortgage terms and conditions.
11. A number of Halifax mortgages are subject to an interest rate that is calculated by reference to the SVR, for example a discounted rate of SVR minus 1% or an enhanced rate of SVR plus 1%. Interest rates at SVR or calculated by reference to the SVR are referred to in this Notice as an 'SVR-related rate'. Where a customer has any part of their mortgage on an SVR-related rate and where an early repayment charge (ERC) applies, they are considered to be "locked in" to the SVR.
12. The Terms and Conditions of some Halifax customers' mortgages contain a provision (the SVR Cap) which limits the SVR to a set percentage over the Bank of England Official Bank Rate (BR). When the SVR Cap is changed, BOS must give all customers that are "locked in" to the SVR 30 days notice in writing of the change and advise them that, if they wish to, they may fully repay their mortgage free of any ERC within 3 months. This places "locked in" customers in effectively the same position as customers who are not "locked in" to the SVR when the SVR Cap is increased.
13. BOS changed the Halifax SVR Cap on 31 October 2008 from 2% to 3% over BR and subsequently increased the margin between BR and SVR on 1 January 2009 from 2% to 2.75% over BR and again on 1 February 2009 to 3% over BR.

Communications with customers regarding the SVR Cap

14. In August 2009, following a number of customer complaints, the FSA raised concerns with BOS regarding changes to the Halifax SVR Cap on a number of historic mortgages. Following a review of communications sent to Halifax customers regarding changes to the SVR, the FSA was concerned that Mortgage Offer Letters sent to customers might have suggested that the SVR Cap applied to a wider

proportion of Halifax customers than was set out in the underlying Terms and Conditions.

15. The FSA and BOS agreed that the SVR Cap and its applicability as set out in the following paragraph which was included in certain Mortgage Offer Letters issued by BOS between 20 September 2004 and 16 September 2007 ("the Cap Summary"), had the potential to cause confusion to some customers:

'We have set a limit on the Halifax Standard Variable Rate so that it will not be more than 2% above Bank of England repo rate. We can change the 2% limit but, before we do, we will give 30 days notice to customers who pay interest at Halifax Standard Variable Rate, a discounted rate or an added rate and are subject to an early repayment charge. Those customers will then have three months to repay their mortgage if they want to, without having to pay the early repayment charge. This does not apply to customers who pay interest at a fixed, capped or tracker rate.'

16. BOS accepted that the Cap Summary had the potential to cause confusion to customers who were "locked in" to the SVR because, whilst it clarified the position regarding the "locked in" period of their mortgage, it may have caused confusion as to what the future position would be if they were subsequently not locked into the SVR. BOS also accepted that the Cap Summary had potential to cause confusion to customers who were not "locked in" to the SVR because it might not have made clear the fact that the SVR Cap did not apply to them.

Voluntary Variation of Permission

17. BOS applied for a VVOP on 16 February 2011. The VVOP required BOS to establish and operate the Programme under which it would, among other things, determine which payments and/or actions should be taken in respect of defined categories of customers, send a letter to those customers and make such payments as required.
18. Under the terms of the VVOP, it was agreed that customers who at that time were, or had previously been, "locked in" to the SVR would be sent a letter setting out the position which would apply after they were no longer "locked in" to the SVR and

would be paid a goodwill sum of £250 each in respect of any potential confusion as to when the SVR Cap applied to them. It was also agreed that customers not “locked in” to the SVR would be sent a letter explaining the operation of the SVR Cap and that they would be paid a goodwill sum equal to the difference between the amount of interest charged and the amount which would have been charged if interest had been capped at 2% above BR for the period from 1 January 2009 (when the SVR was first changed) to the date the Programme was put into effect. The Programme outlined in the VVOP was due to be completed by the end of April 2011.

Identification of an issue with the Programme

19. In May 2011, the FSA identified that there were a number of customers with Halifax mortgages who appeared to be experiencing problems in obtaining the goodwill payments that they expected under the Programme. These issues were identified through the monitoring of a consumer forum website by the FSA.
20. A number of the Halifax mortgage customers who posted on the website stated that they had taken out further advances on their mortgages and outlined information that they had received; namely that they had moved to new Terms and Conditions when making the change to their mortgage and were therefore not eligible for any goodwill payment. However, several customers asserted that the Mortgage Offer Letter they received on taking out a further advance stated that the Terms and Conditions of their existing mortgage would apply to their further borrowing. The website postings indicated that a number of customers were asked by the firm to take their Mortgage Offer Letter into a Halifax branch to be copied.
21. The FSA raised this issue with BOS on 16 May 2011 and asked it to investigate in order to establish whether there was a problem with the implementation of the Programme. BOS was not aware of the postings on the website but had received a small number of complaints directly from customers stating that they had not received the goodwill payments that they were expecting; the first of these complaints was received by BOS on 13 April 2011. The complaints were at that stage under investigation by BOS.

22. On 26 May 2011 BOS confirmed that its initial enquiries had revealed that for a period after September 2007 some Halifax mortgage customers who had made a change to their mortgage had been incorrectly sent a Mortgage Offer Letter which stated that their existing Terms and Conditions would continue to apply. BOS indicated that it was continuing to investigate the matter so was not aware of the full extent of the problem at that time.

Errors in the information held on BOS mortgage systems

23. On 6 June 2011 BOS met with the FSA and outlined the findings of their enquiries. BOS explained that it had become apparent that some customers who had taken out further advances (FAD), completed a product transfer (PT) or had been party to a transfer of mortgaged property (TOMP) between 16 September 2007 and 9 August 2008 had been excluded from the Programme incorrectly.
24. During the meeting on 6 June 2011 BOS advised that PricewaterhouseCoopers had been engaged to undertake an independent review to identify the customers that had been inadvertently excluded from the Programme.
25. Three errors were identified which resulted in BOS mortgage systems holding incorrect information. The first of these errors resulted from an inadequate systems integration and the other two errors were the result of manual processing errors.

Systems Inconsistency

26. BOS has in place, among others, two particular systems in relation to the administration of mortgages. The first is the mortgage account administration system (the Borrowers system). This system recorded the latest version of the terms and conditions. The second is the mortgage offer document production system (the CSF system). This system generated Mortgage Offer Letters based upon the Terms and Conditions that were applicable at the time. During the period between 16 September 2007 and 9 August 2008 the Borrowers system and the CSF system were not properly synchronised. This meant that the CSF system generated incorrect Mortgage Offer Letters for approximately 160,000 customers who were on version 22 of the mortgage Terms and Conditions containing the SVR Cap (having opened their mortgage

accounts between 20 September 2004 and 16 September 2007) and who subsequently varied their mortgage arrangements through a FAD, PT or TOMP between 16 September 2007 and 9 August 2008.

27. The Mortgage Offer Letter generated by the CSF system and sent to these 160,000 customers stated that the existing Terms and Conditions (Version 22 which contained the SVR Cap) would continue to apply to their mortgage arrangement. However, these customers were recorded on the Borrowers System as having been moved onto the new Terms and Conditions (Version 23) which did not contain the SVR Cap.

Manual Error – Deed of Variation Customers

28. From September 2004 until May 2006 the Mortgage Offer Letters sent to customers effecting a PT, FAD or TOMP stated they would be moved to the most current version of the Terms and Conditions, namely Version 22. As part of this process a customer was required to sign and return to the Bank a Deed of Variation (Deed). Upon receipt of the signed Deed, staff were required to manually update the Borrowers system to reflect the move to Version 22. However this manual change was not always effected and as a result approximately 60,000 customers' details were not updated on the Borrowers System.
29. Consequently the Borrowers System did not record these customers as having moved onto Version 22 of the Terms and Conditions and instead recorded them as being subject to Version 21 of the Terms and Conditions (which did contain the SVR Cap but in relation to which customers did not receive the Cap Summary).

Manual Error – Customers who cancelled a completed Product Transfer (“PT”) Transaction

30. When a PT was requested by a customer this would trigger a move to the latest Terms and Conditions. From late 2008, it was the policy to allow Halifax PT customers to reverse or cancel a completed PT transaction if the customer decided against it. If a customer decided to reverse or cancel a completed PT transaction a manual change was required to the Borrowers System to revert the customer back to the original Terms and Conditions. However, this change was not always completed and as a

result the details for approximately 30,000 customers were not updated on the Borrowers System.

31. Consequently these customers were not moved back to Version 22 of the Terms and Conditions (which contained the SVR Cap) and were instead recorded on the Borrowers System as being subject to Version 23 of the Terms and Conditions (which did not contain a SVR Cap).

The failure to identify these errors by BOS

32. The Systems Inconsistency Error was fixed through an unrelated mortgage project which was implemented on 9 August 2008. However, the impact on 160,000 Halifax mortgage customers who had received Mortgage Offer Letters containing incorrect information was only identified following complaints from customers regarding the implementation of the Programme and the subsequent investigation by BOS.
33. The first of the Manual Errors identified above ceased to be an issue for new transactions in May 2006 when the PT, FAD, TOMP process was changed so that the Deed type was automatically updated rather than requiring a manual update. However, the fact that a number of customers details had not been manually updated previously as required was not identified at the time of the process change. This Manual Error was only identified following complaints from customers regarding the implementation of the Programme and the subsequent investigation by BOS. The records for the 60,000 customers affected by this Manual Error were subsequently rectified through a programme to review and where necessary retrospectively correct records for affected customers which was carried out in November 2011.
34. The second of the Manual Errors identified above was also rectified in November 2011 as part of the same programme to review and where necessary retrospectively correct records for affected customers. The fact that a number of customers details (approximately 30,000) had not been manually changed to reflect the cancellation of their PT transaction was only identified following complaints from customers regarding the implementation of the Programme and the subsequent investigation by BOS.

Impact on affected Halifax mortgage customers

35. Until these errors were identified, some of the information held by BOS in relation to approximately 250,000 Halifax mortgage customers was incorrect.
36. The 250,000 affected Halifax mortgage customers had all received Mortgage Offer Letters which had the potential to cause confusion about the application of the SVR Cap. The affected Halifax mortgage customers did not receive subsequent correspondence regarding variations to the SVR Cap as they should have done because they were recorded on BOS mortgage systems as being subject to Terms and Conditions that did not contain the SVR Cap.
37. In particular around 15% of the affected customers were “locked in” to the SVR and these customers did not receive advance written notification reminding them that they could fully repay their mortgage free of any ERC within 3 months of an SVR Cap variation. Without having received this written notification it is possible that these customers believed that they would be subject to an ERC if they chose to repay their mortgage as a result of an SVR Cap variation. Therefore, these customers were not in a position to make informed decisions about their mortgage accounts.
38. The 250,000 customers were also incorrectly excluded from the Programme because they were not recorded on the Borrowers System as being subject to Version 22 of the Terms and Conditions. Of these, around 160,000 were due to receive payments under the terms of the Programme.

Unnecessary payments to customers

39. In addition to excluding a class of customers from the Programme, BOS also erroneously included customers who were out of the scope of the VVOP. The two main categories of customers who received goodwill payments incorrectly were:
 - (1) Customers subject to Version 22 of the Terms and Conditions who had received a Mortgage Offer Letter that did not contain the Cap Summary. BOS incorrectly

paid approximately £18.8 million of goodwill payments to 20,000 customers in this category.

(2) Customers who were considered to be subject to Version 22 of the Terms and Conditions in March 2011 but following corrections implemented to HBOS mortgage systems in November 2011 should have in fact been subject to another Version of the Terms and Conditions. BOS incorrectly paid approximately £1.6 million of goodwill payments to 1,700 such customers.

40. In total 33,700 customers were incorrectly included in the Programme, of which 22,700 customers were erroneously given goodwill payments of £20.4 million. BOS has confirmed that it will not seek to recover this money from customers.

BOS response to the discovery of the Systems Inconsistencies and Manual Errors

41. BOS accepts that there were the Systems Inconsistencies and Manual Errors described above and that these weaknesses led to some inaccuracies in the customer data held on the bank's systems. It also accepts that these inaccuracies impacted upon the implementation of the Programme. However, there was, at the time of implementation of the Programme, no reason for BOS to doubt the reliability of its systems or the accuracy of reports produced as to the mortgage conditions that each customer was on.

42. BOS has undertaken a detailed investigation to identify the nature and extent of the issues raised during the implementation of the Programme and conducted a comprehensive assurance programme in order to ensure that the information on BOS systems is now correct and complete. No customer initially omitted from the Programme has ultimately suffered any loss or detriment as a result of the error

FAILINGS

43. The regulatory provisions relevant to this Final Notice are set out at Annex A.

44. The FSA finds that BOS breached Principle 3 in that it relied upon incorrect records held on BOS mortgage systems between 2004 and 2011. The BOS mortgage systems recorded incorrect information in relation to the mortgage accounts of over 250,000

customers because of the Systems Inconsistency and Manual Errors outlined above but BOS did not identify these errors or rectify the Manual Errors until complaints were received in respect of the Programme in 2011.

45. There was a substantial reliance by BOS on manual processes in respect of the BOS mortgage systems from 2004 to 2011. Errors resulting from those manual processes led to incorrect information being held in relation to two substantial groups of Halifax mortgage customers. Those errors were not identified by BOS until assurance work was carried out following customer complaints made regarding the implementation of the Programme. The controls that were in place in order to prevent or identify any errors resulting from the manual processes used in relation to the BOS mortgage system were therefore insufficient.
46. Additionally, BOS did not separately verify that the information held on its mortgage systems was correct and complete at any point before 2011 when the Programme was implemented. The FSA considers it highly unlikely that BOS would have uncovered the impact of the systems inconsistency error if customers had not complained about their exclusion from the Programme. Therefore the negative impact on affected customers would have been ongoing and it is unclear when, if at all, BOS would have identified this as a widespread problem.

SANCTION

47. In light of the FSA's findings, the FSA considers that the imposition of a public sanction is both justified and proportionate in all the circumstances.
48. In determining the financial penalty, the FSA has had regard to its policy on the imposition of financial penalties which is set out in Chapter 6 of the Decision Procedure & Penalties Manual (DEPP) and forms part of the FSA Handbook. The FSA has also had regard to Chapter 7 of its Enforcement Guide.
49. On 6 March 2010 the FSA's new penalty framework came into force. BOS's misconduct covers a period straddling before and after 6 March 2010 but the FSA considers that the gravamen of the misconduct is before 6 March 2010. The FSA has

therefore assessed the financial penalty under the regime in force prior to 6 March 2010.

50. DEPP 6.5.2G sets out the factors that may be of particular relevance in determining the appropriate level of financial penalty for a firm or approved person. The criteria are not exhaustive and all relevant circumstances of the case are taken into consideration. In determining the appropriate level of sanction, the FSA has had regard to the factors from DEPP 6.5.2G listed below.

Deterrence

51. The financial penalty is required to promote high standards of regulatory conduct by deterring firms which have breached regulatory requirements from committing further breaches, deterring other firms from committing similar breaches and demonstrating generally to firms the benefits of compliant behaviour.

The nature, seriousness and impact of the breach in question

52. The FSA has had regard to the seriousness of the breaches, including the nature of the requirements breached, the nature and duration of the breaches and the number of customers who were impacted. For the reasons set out in paragraph 4 of this Notice, the FSA considers the breaches by BOS to be serious. However, the FSA has also taken into account the mitigating factors outlined at paragraphs 41 and 42 of this Notice.

The size, financial resources and other circumstances of the firm

53. There is no evidence to suggest that BOS is unable to pay the penalty.

Conduct following the breach

54. Since identifying the nature and extent of the issues raised during the implementation of the Programme BOS has undertaken a comprehensive assurance programme to ensure that the information on BOS systems is correct and complete. BOS has co-operated fully with the FSA in the course of its investigation.

Disciplinary record and compliance history

55. BOS has not previously been the subject of disciplinary action by the FSA in relation to the administration of BOS mortgage systems, but has been the subject of disciplinary action by the FSA for breaches of Principles 2 and 3.

Previous action taken by the FSA in relation to similar findings

56. In determining whether and what financial penalty to impose on BOS the FSA has taken in account action taken by the FSA in relation to other authorised persons for comparable behaviour.

Conclusion as to financial penalty

57. Accordingly, the FSA considers it necessary and proportionate to impose a financial penalty of £4.2 million, pursuant to section 206 of the Act, on the grounds that BOS failed to take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems.

PROCEDURAL MATTERS

Decision maker

58. The decision which gave rise to the obligation to give this Notice was made by the Settlement Decision Makers.
59. This Final Notice is given under and in accordance with section 390 of the Act.

Manner of and time for Payment

60. The financial penalty must be paid in full by BOS to the FSA by no later than 2 November 2012, 14 days from the date of the Final Notice.

If the financial penalty is not paid

61. If all or any of the financial penalty is outstanding on 3 November 2012, the FSA may recover the outstanding amount as a debt owed by BOS and due to the FSA.

Publicity

62. 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 FSA must publish such information about the matter to which this notice relates as the FSA considers appropriate. The information may be published in such manner as the FSA considers appropriate. However, the FSA may not publish information if such publication would, in the opinion of the FSA, be unfair to you or prejudicial to the interests of consumers.
63. The FSA intends to publish such information about the matter to which this Final Notice relates as it considers appropriate.

FSA contacts

64. For more information concerning this matter generally, contact Bill Sillett at the FSA (direct line: 020 7066 5880 / fax: 020 7066 5881) of the Enforcement and Financial Crime Division of the FSA.

Tom Spender
Project Sponsor
FSA Enforcement and Financial Crime

ANNEX A

STATUTORY PROVISIONS, REGULATORY GUIDANCE AND POLICY

RELEVANT STATUTORY PROVISIONS

1. The FSA's statutory objectives are set out in section 2(2) of the Act. The relevant objective for the purpose of this case is the protection of consumers.

2. Section 206(1) of the Act provides that:

'If the FSA 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.'

3. Bank of Scotland plc is an authorised person for the purposes of section 206 of the Act. The requirements imposed on authorised persons include those set out in the FSA's Principles and Rules made under section 138 of the Act. Section 138 provides that the FSA may make such rules applying to authorised persons as appear to be necessary or expedient for the purposes of meeting any of the FSA's objectives, including protecting the interests of consumers.

REGULATORY PROVISIONS

4. In exercising its power to impose a financial penalty, the FSA has had regard to the relevant regulatory provisions and policy published in the FSA Handbook. The main provisions that the FSA considers relevant to this case are set out below.

5. The FSA's Principles for Businesses are general statements of the fundamental obligations of firms under the regulatory system. They derive their authority from the FSA's rule making powers as set out in the Act and reflect the FSA's regulatory objectives.

6. The FSA's Principles constitute requirements imposed on authorised persons under the Act; breaching a Principle and/or a Rule makes a firm liable to disciplinary sanctions.

7. The Principle relevant to this case is Principle 3 of the FSA's Principles for Businesses which states that:

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

DECISION PROCEDURE AND PENALTIES MANUAL ("DEPP")

8. In deciding to take the action described above, the FSA has had regard to the guidance it has published in Chapter 6 of DEPP and under section 124 of the Act, which requires the FSA to "*issue a statement of its policy with respect to the imposition of penalties under section 123 and the amount of*" such penalties.
9. DEPP 6.1.2G provides that the principal purpose of imposing a financial penalty is to promote high standards of regulatory and/or market conduct by deterring persons who have committed breaches from committing further breaches, helping to deter other persons from committing similar breaches, and demonstrating generally the benefits of compliant behaviour. Financial penalties are therefore tools that the FSA may employ to help it to achieve its regulatory objectives.
10. The FSA's new penalty regime applies to breaches which take place on or after 6 March 2010. The misconduct in this case took place between 2004 and 2011, the majority of that period falls under the old penalties regime. The FSA has therefore applied the provisions of DEPP Chapter 6 in force prior to 6 March 2010 to determine the level of financial penalty.