---

**FINAL NOTICE**

---

To: Peter Cummings

Date of birth: 19 July 1955

FSA Reference Number: PJC01301

Date: 12 September 2012

**TAKE NOTICE: The Financial Services Authority of 25 The North Colonnade, Canary Wharf, London E14 5HS ("the FSA") gives you final notice that it has taken the following action:**

## 1. ACTION

1.1. For the reasons given in this notice, the FSA hereby:

(1) imposes on Peter Cummings a financial penalty of £500,000, pursuant to section 66 of the Financial Services and Markets Act 2000 (the "Act"), on the grounds that during the period January 2006 to December 2008 (the "Relevant Period"):

(a) he failed to comply with Statement of Principle 6 of the FSA's Statements of Principle and Code of Practice for Approved Persons ("Statement of Principle 6"); and

(b) he was knowingly concerned in a contravention by Bank of Scotland plc (the "Firm") of Principle 3 of the FSA's Principles for Businesses ("Principle 3");

(2) makes an order, pursuant to section 56(2) of the Act, prohibiting him from performing any significant influence function in any authorised firm that is a Bank, Building Society, BIPRU investment firm, Insurer or part of a group containing such firms (as defined in the FSA Handbook) on the grounds that he lacks competence and capability to perform such functions. This order takes effect from 12 September 2012.

1.2. Following written and oral representations, the FSA issued a Decision Notice to Mr Cummings on 7 September 2012, which notified him that it had decided to take the above action. Mr Cummings has not referred the matter to the Upper Tribunal (Tax and Chancery Chamber).

## 2. SUMMARY OF THE REASONS FOR THE ACTION

2.1. The FSA has decided to take this action as a result of the conduct of Mr Cummings in his performance of the director (CF1) controlled function in relation to the Firm's Corporate Division during the Relevant Period.

2.2. Mr Cummings was chief executive of the Corporate Division throughout the Relevant Period.

2.3. Mr Cummings was appointed as chief executive of the Corporate Division in January 2006. From the outset of his appointment Mr Cummings understood that the Corporate Division's portfolio was high risk, as a consequence of the substantial exposure to: property and large borrowers; risk capital; large highly leveraged transactions; and assets with a low credit quality. This meant that the portfolio was very vulnerable to a downturn in the economic cycle. Furthermore under his direction the Corporate Division pursued an aggressive growth strategy. This high risk business and lending strategy required a commensurately robust level of control and oversight in order to achieve effective assessment, management and mitigation of the risks in the portfolio.

2.4. Given the high level of risk and exposure to the economic cycle in the portfolio, the effective assessment, management and mitigation of credit risk required the following:

(1) an effective control framework for the sanctioning and monitoring of individual transactions;

(2) an effective framework for the management of credit risk across the portfolio as a whole;

(3) an effective framework for the distribution of risk through sell-down, by syndication or other means;

(4) an effective process for the prompt identification and management of transactions which showed signs of stress;

(5) a culture which gave due weight to credit risk management; and

(6) reliable management information.

2.5. Although Mr Cummings made efforts to implement improvements between January 2006 and March 2008, he failed to take reasonable steps to assess, manage or mitigate the risks involved in the aggressive growth strategy which the Corporate Division, under his direction, was pursuing. The aggressive growth strategy, which had a specific focus on high risk, sub-investment grade lending was pursued despite known weaknesses in the control framework, which meant that there was a failure to provide robust oversight and challenge to the business.

2.6. Furthermore between April and December 2008, Mr Cummings failed to take reasonable care to ensure that the Corporate Division adequately and prudently managed a significant number of high value transactions which showed signs of stress.

2.7. Mr Cummings' conduct constitutes a failure to exercise due skill, care and diligence in managing the business of the Firm for which Mr Cummings was responsible in his controlled function.

2.8. Further, the Firm failed to take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems, throughout the Relevant Period. Mr Cummings was knowingly concerned in this failure by the Firm.

2.9. The FSA accepts that:

(1) a number of the deficiencies in the control framework and the issues with the approach to risk management pre-dated the appointment of Mr Cummings as chief executive of the Corporate Division;

(2) Mr Cummings initiated a number of projects which were designed to improve the control framework and the approach to risk management and implemented a number of improvements during the Relevant Period;

(3) there was a severe financial crisis and economic downturn in the course of the Relevant Period, the full severity of which was not reasonably foreseeable during the early part of the Relevant Period. The financial crisis and economic downturn had a significant impact on the business;

(4) the assessment of credit quality, impairment and the appropriate level of provisioning requires the exercise of management judgement;

(5) whilst a significant degree of reliance was placed upon Mr Cummings' judgement and experience he did not take all of the decisions alone. The FSA acknowledges that critical business decisions were taken collectively; and

(6) Mr Cummings did not deliberately or recklessly breach regulatory provisions.

2.10. Notwithstanding these matters, the FSA considers that Mr Cummings' conduct was not sufficient to discharge his regulatory obligations. These matters do however serve as mitigation in relation to the level of penalty.

2.11. The FSA has also taken into account in determining the level of penalty, the fact that Mr Cummings voluntarily waived his contractual entitlement to a deferred bonus of £1.3 million when he left the Firm in January 2009. This bonus related to Mr Cummings' performance in 2007 and was due to be paid to him in 2010.

2.12. The FSA considers that Mr Cummings' standard of conduct during the Relevant Period fell below that which would have been reasonable in all the circumstances. The FSA considers that during the Relevant Period Mr Cummings failed to comply with his regulatory responsibility as set out in Statement of Principle 6 and he was knowingly concerned in the Firm's contravention of Principle 3. The FSA considers that a financial penalty of £500,000 is appropriate and justified. Further, the FSA considers that it is appropriate to make an order prohibiting Mr Cummings from performing any significant influence function in any authorised firm that is a Bank, Building Society, BIPRU investment firm, Insurer or part of a group containing such firms (as defined in the FSA Handbook).

## 3. RELEVANT STATUTORY PROVISIONS, RULES AND GUIDANCE

### Relevant Statutory Provisions

3.1. The FSA's statutory objectives, set out in section 2(2) of the Act, are the maintenance of confidence in the financial system, promoting financial stability, the protection of consumers and the reduction of financial crime.

3.2. The FSA has the power, pursuant to section 66 of the Act, to impose a financial penalty of such amount as it considers appropriate where it appears to the FSA that a person is guilty of misconduct and it is satisfied that it is appropriate in all the circumstances to take action against him.

3.3. A person is guilty of misconduct if, while an approved person, he fails to comply with the Statements of Principle issued under section 64 of the Act or if he is knowingly concerned in a contravention by the relevant authorised person of a requirement imposed on that authorised person by or under the Act.

3.4. The FSA has the power, pursuant to section 56 of the Act, to make a prohibition order if it appears to the FSA that an individual is not a fit and proper person to perform functions in relation to a regulated activity carried on by an authorised person, exempt person or exempt professional firm. Pursuant to section 56(2) of the Act, such an order may relate to a specified function, any function falling within a specified description or any function.

**FSA Rules and Guidance**

3.5. APER was issued pursuant to section 64 of the Act and contains general statements regarding the fundamental obligations of approved persons under the regulatory system.

3.6. Statement of Principle 6 states: "*An approved person performing a significant influence function must exercise due skill, care and diligence in managing the business of the firm for which he is responsible in his controlled function.*" (APER 2.1.2P).

3.7. FSA's Principles for Businesses ("PRIN") was issued pursuant to section 138 of the Act and contains general statements regarding the fundamental obligations of firms under the regulatory system.

3.8. Principle 3 states: "*A firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems*" (PRIN 2.1.1R).

3.9. PRIN 3.2.3R states that Principle 3 also applies with respect to the carrying on of unregulated activities in a prudential context.

3.10. SUP 10.4.5R specifies controlled functions.

3.11. SUP 10.6.4R states that the CF1 director function is the function of acting in the capacity of a director of the firm.

3.12. FIT 1.3.1G states that the FSA will have regard to, inter alia, a person's competence and capability when assessing the fitness and propriety of a person to perform a particular controlled function.

**FSA Guidance and Policy**

3.13. The FSA guidance and policy relevant to the above statutory provisions and rules are set out in the Annex attached to this Notice.

## 4. FACTS AND MATTERS RELIED ON

4.1. Unless otherwise stated, the facts and matters relied on below relate to the Relevant Period, namely January 2006 to December 2008.

**HBOS Structure**

4.2. Following the merger of Halifax Group plc and Bank of Scotland in 2001, the Group (also known as HBOS) of which the Firm was part, operated a federal structure. The federal structure meant that the divisional chief executives, who were members of the Group Board, were given significant autonomy to manage the business of their division and significant reliance was placed on their judgement. Each division had its own Risk function, which reported to the divisional chief executive.

4.3. HBOS comprised the following business divisions:

(1) the Retail Banking Division;

(2) the Insurance and Investment Division;

(3) the Corporate Banking Division ("Corporate" or "the Corporate Division");

(4) the International Division;

(5) the Treasury Division; and

(6) the Asset Management Division.

4.4. These business divisions were supported and/or overseen by central Group functions, in particular Group Finance, Group Risk and Group Internal Audit.

4.5. In relation to the governance of risk, HBOS operated a "three lines of defence" model whereby:

(1) the first line of defence operated at divisional level as each division had its own risk function: primary responsibility for risk management rested with the division's chief executive;

(2) the second line of defence operated at Group level: this included oversight by Group Risk, Group Finance, the Executive Committee of the Group Board ("EXCO") and the Group Chief Executive; and

(3) the third line of defence included Group Internal Audit and the Group Audit Committee.

**Description of the business of the Corporate Division**

4.6. The business of the Corporate Division was structured as follows[1]:

(1) Real Estate;

(2) Joint Ventures, which provided risk capital funding;

(3) Integrated, Structured and Acquisition Finance ("ISAF"), which included risk capital funding;

(4) Commercial;

(5) Specialised Industry Finance ("SIF"); and

(6) Asset Solutions.

4.7. Each of the business areas was headed by a managing director, who reported to Mr Cummings.

4.8. Other functions within the Corporate Division included:

(1) Risk; and

(2) Finance.

4.9. Each of these functions was headed by a managing director, who reported to Mr Cummings.

[1] At the beginning of 2006 Mr Cummings made organisational changes which restructured the business by asset class. At that time Real Estate, Commercial and Joint Ventures all sat within the Relationships business area. The details set out here post-date a further restructure in around July 2007. Despite these structural changes, the types of business conducted by the Corporate Division did not change.

**The position and remit of Mr Cummings**

4.10. Prior to the Relevant Period, from March 2001 Mr Cummings had been a managing director within the Corporate Division. Since April 2004, he had responsibility for ISAF. In July 2005 he was appointed deputy chief executive of the Corporate Division, with a view to taking on the role of chief executive on 1 January 2006.

4.11. On 1 January 2006 Mr Cummings was appointed an executive director of HBOS plc. On the same date he became chief executive of HBOS's Corporate Division. Throughout the Relevant Period Mr Cummings held the CF1 (director) controlled function for the primary entities through which HBOS's Corporate Division operated. From 17 September 2007 these entities were consolidated into Bank of Scotland plc[2].

4.12. As a director and divisional chief executive Mr Cummings had specific responsibility for:

(1) the formulation and implementation of the business strategy of the Corporate Division and for the profitability and overall performance of Corporate. One aspect of this specific responsibility was the formulation of a business plan for the Corporate Division on an annual basis. The divisional plan would be the subject of discussion and challenge at Group level prior to finalisation;

(2) the overall control framework within the Division. One aspect of this specific responsibility was the maintenance of an effective and efficient system of internal control to enable Corporate to deliver its results within the risk appetite approved by the Group Board; and

(3) managing the risks of the Corporate Division within the risk appetite approved by the Group Board. One aspect of this specific responsibility was the identification and evaluation of the risks facing Corporate. Mr Cummings had specific responsibility for the oversight of the functions and departments within the Corporate Division identified at paragraphs 4.6 and 4.8 above.

[2] As at 1 January 2006 the business of the Corporate Division was conducted primarily through the authorised entities of the Governor and Company of the Bank of Scotland, Halifax plc and Capital Bank plc. On 17 September 2007, pursuant to the HBOS Group Reorganisation Act 2006, all assets and liabilities in Halifax plc and Capital Bank plc were transferred to the Governor and Company of the Bank of Scotland, which was renamed Bank of Scotland plc.

4.13. Mr Cummings was the chair of the Corporate Credit Risk Committee until November 2007. This committee was responsible for considering and developing credit risk strategies and policies, levels of portfolio exposure and parameters for sector limits to be adopted within all areas of the Division. He was also responsible for ensuring that lending policies were appropriate.

4.14. Mr Cummings was also the chair of the Executive Credit Committee which was responsible for sanctioning lending decisions on high value or complex credit transactions. Even if not present at the meeting, Mr Cummings was required to sign-off any applications approved in his absence to indicate his awareness and approval of all such transactions. In addition, the Executive Credit Committee was responsible for conducting periodic reviews of high value transactions and/or borrowers.

**The risk profile of the business**

4.15. The Corporate Division was the highest risk part of HBOS's business.

4.16. The Corporate book had a higher risk profile than equivalent books at other major UK banking groups.

4.17. The risk profile of the Corporate book was high in that:

(1) it had a high degree of exposure to property and to large single name borrowers ("concentration risk");

(2) it had a substantial exposure to equity and subordinated tranches of debt below mezzanine ("risk capital");

(3) it had a substantial exposure to large highly leveraged transactions and the leveraged finance market; and

(4) the credit quality of the portfolio was low in that around 75% of it was sub-investment grade[3].

4.18. In relation to concentration risk:

[3] Standard & Poor's state that the term 'sub-investment grade', or 'speculative grade', generally refers to debt securities where the issuer currently has the ability to repay but faces significant uncertainties, such as adverse business or financial circumstances that could affect credit risk.

(1) the Corporate Division's exposure to commercial property was high throughout the Relevant Period and significantly higher than equivalent exposures at other major UK banking groups. At the start of 2006, 52% (or £44.4 billion) of Corporate's loan book (by drawn amounts) was exposed to the commercial property market. By the end of 2008, this proportion had risen to 56% (or £68.1 billion). The level of the commercial property concentration in the Corporate book meant that it was heavily exposed to a downturn; and

(2) the Corporate Division had a significant exposure to large single name borrowers. At the start of 2006, the top 30 large exposures accounted for 15% of the value of the Corporate portfolio (£19.2 billion). By the end of March 2008, this had increased to 23% (£34.1 billion). In many transactions, Corporate's exposure to a large single name borrower also involved commercial property and/or risk capital and/or was highly leveraged, further deepening the level of concentration and risk. The size of these exposures meant that any default would have a high impact on the book.

4.19. In relation to the Corporate Division's exposure to risk capital:

(1) it primarily comprised:

(a) equity stakes and holdings of subordinated debt from integrated finance transactions originated by ISAF and Joint Ventures; and

(b) equity investments in the Fund Investments area within ISAF;

(2) this was the highest risk area of the Corporate book, given the absence of security and the lower levels of control over assets compared to transactions where it held senior debt;

(3) in relation to integrated finance transactions by which the Corporate Division provided both debt and equity finance to its clients, these risks were compounded by issues regarding conflicts of interest, which would become particularly acute if the transaction became stressed as the interests of senior debt holders would differ from those of risk capital holders;

(4) the Corporate Division operated a "one-stop-shop" model for integrated finance, which meant that the risk in individual transactions received less scrutiny than if debt and equity had been required to be sanctioned and managed separately;

(5) the Corporate Division's exposure to risk capital grew significantly over the course of the Relevant Period. At the start of 2006, the reported value of Corporate's debt securities and equity shares (by drawn amounts) was £2.3 billion. By the end of August 2008, this had increased by 139% to £5.5 billion; and

(6) in seeking to meet challenging targets, Corporate realised significant profits from this area by selling investments. In order to achieve increased and sustainable earnings from Corporate's investment portfolio despite these realisations, Mr Cummings directed the business to maintain a strong and continuous pipeline of new integrated finance deals and fund investments. This increased the exposure to risk capital.

4.20. In relation to large leveraged transactions, these deals involved lending over £75 million or a substantial equity investment. This meant that the deals had to be sanctioned by the Executive Credit Committee which Mr Cummings chaired. There was a significant increase in the volume and complexity of deals that this committee approved during 2006 and 2007. There were 199 approvals of lending in excess of £75 million in 2006 (which represented total lending of £56 billion), which increased to 361 such approvals in 2007 (which represented total lending of £96.2 billion). There were 56 approvals of lending over £250 million in 2006 (which represented total lending of £36.2 billion), which increased to 110 such approvals in 2007 (which represented total lending of £64 billion). The size of these transactions meant that any default would have a high impact on the book.

4.21. The credit quality of the portfolio was low. The Corporate Division had a specific focus on sub-investment grade lending. The average portfolio rating reported throughout the Relevant Period was sub-investment grade at around 6.1 (or B+)[4]. (A

[4] 6.1 was HBOS's internal risk rating which when mapped against Standard & Poor's risk rating is B+ or sub-investment grade. Standard & Poor's grade an obligor's overall creditworthiness on a scale ranging from AAA

proportion of Corporate's portfolio was not rated at all, in particular risk capital transactions which comprised the highest risk part of the book. There was therefore limited visibility over the risk inherent in these assets.) The Corporate Division had a higher target portfolio rating of 5.2 (BB), which was still sub-investment grade. However, Corporate had a portfolio that was below this rating throughout the Relevant Period and regularly entered into transactions which had a lower credit rating than the target.

4.22. Throughout the Relevant Period, until competition started to reduce as the financial crisis escalated, the Corporate Division operated in highly competitive markets. The competitive pressures in these markets meant that the Corporate Division often had to increase its exposure on transactions that were already rated sub-investment grade in order to avoid losing the customer to a competitor. As a consequence and at the direction of Mr Cummings, the Division entered into numerous transactions with weak lending criteria and/or aggressive structures, which both reduced the level of control over the borrower and increased the likely impact in the event of a default. Aggressive deal structures (for example high leverage multiples, low margins on pricing, weak covenants and/or riskier subordinated debt tranches such as PIK notes[5]) were a particular feature of the leveraged finance transactions referred to above. These aggressive structures increased underwriting risk as they made it more difficult for the Corporate Division to sell down its exposure.

4.23. The heavy focus on property and risk capital meant that the portfolio was highly exposed to changes in the economic cycle. In benign market conditions, with robust property values and equity returns, the portfolio could be expected to perform strongly. The use of leverage would enhance performance.

4.24. The level of concentration put significant reliance on the effective assessment, management and mitigation of credit risk because:

---

(extremely strong capacity to meet financial commitments) to CC (highly vulnerable) through to D (general default). Ratings of BB and B indicate significant speculative characteristics. A BB rating indicates major ongoing uncertainties and exposure to adverse business, financial or economic conditions. A B rating indicates greater vulnerability. A rating of BB or below is regarded as sub-investment grade.

[5] A PIK note (or payment-in-kind note) is a form of debt financing that pays interest only when the note is redeemed.

(1) the Corporate Division was increasing its exposure at a late stage in the economic cycle;

(2) the portfolio was highly vulnerable to an economic downturn. The level of leverage in the portfolio increased both the risk and the quantum of potential losses; and

(3) a high level of impairments could be anticipated in a downturn given the concentrated nature of the portfolio and its sub-investment grade credit quality.

4.25. Given the high level of risk and exposure to the economic cycle in the portfolio, the effective assessment, management and mitigation of credit risk required the following:

(1) an effective control framework for the sanctioning and monitoring of individual transactions;

(2) an effective framework for the management of credit risk across the portfolio as a whole;

(3) an effective framework for the distribution of risk through sell-down, by syndication or other means;

(4) an effective process for the prompt identification and management of transactions which showed signs of stress;

(5) a culture which gave due weight to credit risk management; and

(6) reliable management information.

4.26. However, as Mr Cummings was aware or should have been aware, there were serious deficiencies in the systems and controls within Corporate throughout the Relevant Period. This remained the case despite his efforts to improve the approach to risk management and the control framework.

**Significant flaws in the control framework**

4.27. The high risk lending strategy which Corporate pursued under Mr Cummings' direction required a commensurately robust control framework. However, as Mr Cummings was aware over the course of the Relevant Period, there were significant issues:

(1) with the effectiveness of the control framework, such that it was not capable of providing robust oversight and challenge to the business;

(2) with the effectiveness of managerial oversight and supervision of the low value/high volume business;

(3) in relation to the culture of the business, such that risk management was regarded as a constraint on the business rather than integral to it; and

(4) as to the quality, reliability and utility of the available management information, which directly affected the effectiveness with which the risks of the business could be assessed, managed and mitigated.

*Sanctioning and Monitoring*

4.28. Mr Cummings relied on the effectiveness of the credit sanctioning process to mitigate the high risk profile of the portfolio. He recognised this to be a key mitigant of the risks associated with increasing the portfolio's exposure to commercial property at a time when he recognised or should have recognised that the market seemed to be reaching a peak. Key features of the sanctioning process included:

(1) a single credit approach whereby individual sanctioning decisions were made without detailed consideration of the wider portfolio;

(2) a high degree of reliance on relationship managers, subject to management supervision and oversight, with regard to credit analysis and due diligence**;**

(3) relationship managers dealing in lower value transactions were delegated significant power to extend further credit to existing customers, subject to management supervision and oversight; and

(4) higher value transactions were considered by key sanctioning committees.

4.29. The low credit quality of transactions which made up the portfolio meant that there was a relatively high risk of default. Effective monitoring of individual transactions and the portfolio as a whole was therefore of particular significance. For example, the monitoring of covenants to identify non-compliance was a key prompt for considering whether to re-rate a transaction and/or for considering whether a transaction should be classified as stressed and/or impaired. Significant reliance was placed on relationship managers to perform effective monitoring, subject to management supervision and oversight.

4.30. However, as Mr Cummings was aware or should have been aware over the course of the Relevant Period:

(1) there were continuing and significant weaknesses in credit skills and processes at all stages of the transaction cycle, with significant issues as to the effectiveness of key controls. Control reports highlighted significant failings in relation to both the sanctioning stage and the subsequent monitoring of transactions;

(2) there were continuing, significant and widespread weaknesses in the effectiveness of management supervision and oversight of relationship managers;

(3) the substantial increase in the volume and complexity of new transactions meant that the key sanctioning committees had less time to scrutinise individual transactions, impacting the effectiveness of the oversight of those committees;

(4) the increasing pressure to increase growth and the significant amount of time and resource which was taken up by a wide range of change management projects meant that less attention would necessarily be paid to risk management; and

(5) as a consequence of these serious deficiencies, the control framework failed to provide robust oversight and challenge to the business.

4.31. As Mr Cummings was aware or should have been aware there were repeated failings during the Relevant Period, across all areas of the business, of key controls. These controls were crucial to the effective sanctioning and monitoring of individual transactions in, for example, the following areas:

(1) due diligence at the outset of a prospective transaction;

(2) the monitoring of adherence to delegated lending authorities;

(3) the completion of conditions precedent;

(4) the perfecting of security;

(5) the monitoring of covenants;

(6) the monitoring of compliance with credit limits;

(7) the indexation of Loan-To-Value data; and

(8) the close monitoring process.

*Culture*

4.32. In relation to the culture of the business, and as Mr Cummings was aware or should have been aware over the course of the Relevant Period:

(1) staff were incentivised to focus on revenue rather than risk, which increased the appetite to increase lending and take on greater risk;

(2) there was a dominant single credit focus, which hindered effective credit risk management across the portfolio as a whole;

(3) the business was resistant to change, which would impede any efforts to improve the control framework and to prioritise risk management;

(4) there was a culture of optimism which affected the attitude towards assessing credit risk in the course of the loan approval process and which also engendered a reluctance to refer stressed transactions to the High Risk team; and

(5) risk management was regarded as a constraint on the business rather than integral to it.

*Management Information*

4.33. In relation to the quality, reliability and utility of the available management information, and as Mr Cummings was aware or should have been aware over the course of the Relevant Period:

(1) the available management information was not sufficient for the purpose of conducting an effective assessment of the portfolio;

(2) the degree of manual intervention was a continuing and major risk;

(3) there was a continuing lack of metrics for the assessment of the effectiveness of the control environment; and

(4) a significant proportion of the portfolio had not been risk-rated.

4.34. As a consequence, the control framework was not sufficiently effective throughout the Relevant Period. This directly impeded the ability of the business to assess, manage and mitigate credit risk.

**Significant issues with the distribution of risk**

4.35. The high risk lending strategy which Corporate pursued under Mr Cummings' direction also required an effective framework for the distribution of risk.

4.36. Corporate entered into transactions as sole underwriter, taking 100% of the exposure onto its book and subsequently seeking to sell this down to a targeted hold position. In this way Corporate ran significantly higher risk in entering into transactions than if it underwrote them on a club basis, whereby the risk (and more of the fees) would be shared with others at the outset.

4.37. Mr Cummings understood that achieving sell down to the target hold position was a vital element of the Corporate business model and that this was of particular significance as a means of reducing the degree of exposure to large leveraged transactions.

4.38. However, as Mr Cummings was aware or should have been aware over the course of the Relevant Period:

(1) the Corporate Division's loans distribution capability was limited in comparison to its peer group and there were issues with the effectiveness and authority of the loans distribution unit;

(2) deal teams were slow to sell down. One of the consequences of sell down was that there was an overall reduction in fee levels which directly affected their results and incentives. They priced transactions primarily in order to secure the business rather than in order to facilitate sell down;

(3) aggressive structures impeded sell-down. However, deal teams continued to structure deals aggressively in order to secure the business; and

(4) in a number of large transactions, the Corporate loans distribution unit expressed concerns as to their ability to sell down particular transactions given the proposed pricing and/or structuring of the transaction. Notwithstanding those concerns the transactions were sanctioned. In a number of these transactions, the target hold was not achieved.

4.39. As a consequence, the framework for the distribution of risk was not effective throughout the Relevant Period. This directly impeded the ability of the business to mitigate credit risk.

**Significant issues with the management of portfolio risk**

4.40. The high risk lending strategy which Corporate pursued under Mr Cummings' direction also required a commensurately robust framework for the management of risk across the portfolio as a whole. However, as Mr Cummings was aware or should have been aware over the course of the Relevant Period:

(1) the dominant single credit focus hindered effective credit risk management across the portfolio as a whole;

(2) Corporate did not have a sophisticated process for defining its risk appetite. Although high level industry sector limits were set and a target portfolio rating

was reported, they were not used effectively to constrain growth or manage the risk across the portfolio as a whole:

(a) sector limits gave the business generous headroom and/or were periodically adjusted to enable the business to meet its targets;

(b) there were no limits set for specific asset classes within the high level sector limits, such that there were no limits specific to the higher risk areas of ISAF and Joint Ventures beyond the overarching industry sector limits; and

(c) transactions were entered into with ratings which were significantly worse than the target or not rated at all.

(3) Corporate did not introduce a risk appetite statement for its risk capital business until June 2008.

4.41. As a consequence, the framework for the management of risk across the portfolio as a whole was not effective throughout the Relevant Period. This directly impeded the ability of the business to assess, manage and mitigate risk.

**Significant issues regarding stressed transactions**

4.42. As set out in more detail at paragraphs 4.100 to 4.125 below, Corporate did not have an effective process for the prompt identification and management of transactions which showed signs of stress. This directly impeded the ability of the business to assess, manage and mitigate credit risk.

**The substantial expansion of the business between January 2006 and March 2008**

4.43. Despite the matters set out at paragraphs 4.27 to 4.42 above, between January 2006 and March 2008, the Corporate Division pursued an aggressive growth strategy under Mr Cummings' direction. Over the course of this period:

(1) succeeding business plans set ever-increasing and highly challenging targets for profit growth. This in turn required growth in the Division's assets. The

high rate of portfolio turnover on the Corporate book (approximately 30% per annum) meant that stronger origination efforts were required every year just to ensure that the size of the loan book did not reduce and that the challenging targets were consistently met and exceeded;

(2) a substantial proportion of the profit growth arose out of higher risk areas of the business, in particular Joint Ventures and ISAF which originated the majority of Corporate's risk capital. The consequence of this was that there was a need to replace these assets at the same point in the cycle when these profits were being realised; and

(3) the average credit quality of new and renewal business remained lower than the target. The portfolio was high risk and sub-investment grade throughout. Furthermore, the credit quality of the portfolio was significantly worse than the target risk rating throughout the period.

4.44. During this period Mr Cummings made repeated statements in internal business plans that the business was adopting a selective and cautious approach to lending.

4.45. Mr Cummings' remuneration structure included, from May 2007, a special incentive scheme whereby he would receive an additional cash incentive equivalent to 100% of his salary if Corporate's profit before tax ("PBT") targets were met, and up to 200% if targets were exceeded. He received an incentive of £1.3 million (equivalent to 200% of salary) in relation to Corporate's performance in 2007.

*The growth of the business in 2006*

4.46. Prior to the start of 2006 Mr Cummings was aware that:

(1) There were indications that the economic cycle was at or reaching a peak;

(2) competitive pressures in the leveraged finance market were having a negative impact on deal structures and increasing underwriting risk;

(3) there were significant unresolved issues with the effectiveness of the control framework, which were exacerbated by issues in relation to culture and management information;

(4) the framework for the management of credit risk across the portfolio was not robust;

(5) the loans distribution framework was not operating effectively; and

(6) the process for the identification and management of stressed transactions was not operating effectively.

4.47. During the course of 2006 organisational changes initiated by Mr Cummings increased his understanding of the significant unresolved issues with the effectiveness of the control framework.

4.48. Despite this, from the outset of and throughout 2006 under Mr Cummings' direction all areas of the business focussed on revenue generation. He did not take reasonable steps to assess, manage and mitigate the potential risks of this strategy.

4.49. The business plan for 2006-2010 (which Mr Cummings inherited from his predecessor) set out the following targets for 2006:

(1) Underlying profit before tax ("UPBT") growth of 9%; and

(2) lending growth of 6.4%.

4.50. During the Group challenge process just prior to his appointment, Mr Cummings had agreed to double the profit target contained in the plan, and he directed the Corporate Division to seek to achieve this revised target on taking up his appointment in January 2006. In the light of the unresolved wide-ranging and serious issues in the business, as summarised at paragraphs 4.27 to 4.42 above, directing growth at these levels was imprudent.

4.51. At the end of 2006, the Corporate Division had achieved the following:

(1) UPBT growth of 17% (which was 8% ahead of plan); and

(2) lending growth of 8%.

4.52. Of particular note, during 2006:

(1) in relation to property, there was a 13% increase in lending;

(2) in relation to risk capital:

(a) the reported book value of Corporate's investment portfolio grew by 42%, despite significant realisations[6];

(b) Joint Ventures' UPBT was 31% above plan; and

(c) ISAF's UPBT was 41% above plan.

(3) in relation to leveraged finance activity:

(a) there were 199 transactions in excess of £75 million, with a total value of £56 billion;

(b) there were 56 transactions in excess of £250 million, with a total value of £36.2 billion; and

(4) in relation to single name exposures, the total value of the top 30 exposures increased by 26% (from £19.2 billion to £24.2 billion), increasing the proportion of these exposures to the overall Corporate portfolio from 15% to 17%.

4.53. The average credit quality of both new and renewal business was significantly worse than the target risk rating. The credit quality was at 6.1 or 6.2 rather than the higher target of 5.2.

4.54. The aggressive and high risk growth strategy which Mr Cummings directed the business to adopt contrasted with statements in the Firm's internal business plan for 2006/2010, which suggested that:

(1) the approach to credit risk was conservative with a constant drive for improved credit quality;

(2) Corporate would continue to apply clear parameters to lending proposals to ensure that the inherent risk in both individual proposals and the portfolio was appropriately managed; and

[6] Increases in reported book value despite significant realisations indicate that (in addition to any fair value uplift) new investments are being taken on to the book.

(3) Corporate would be particularly selective in the business it chose to write.

*The growth of the business in the period January to July 2007*

4.55. By the start of 2007 Mr Cummings was aware or should have been aware that:

(1) there were further indications that the economic cycle was reaching a peak and that a downturn could be anticipated;

(2) there continued to be significant unresolved issues with the effectiveness of the control framework, which were exacerbated by issues in relation to culture and management information;

(3) the framework for the management of risk across the portfolio was still not robust;

(4) the loans distribution framework was still not operating effectively; and

(5) the process for the identification and management of stressed transactions was still not operating effectively.

4.56. During the first quarter of 2007, Mr Cummings also became aware of increased concerns within the Firm around the leveraged finance market. In particular, in March 2007 Group Risk advised that there should be caution in relation to the leveraged market and that targeting further growth in that area should be avoided.

4.57. Despite this, Mr Cummings continued to direct the business to focus on revenue generation and aggressive growth. He did not take reasonable steps to assess, manage and mitigate the potential risks of this strategy.

4.58. Corporate had originally proposed targets for 2007 of 10-12% UPBT growth. During the Group challenge process HBOS directed Corporate to increase this target substantially. In finalising the business plan for 2007/2011, Mr Cummings set the following targets for 2007:

(1) UPBT growth of 22%; and

(2) lending growth of 9%.

4.59. The targets were increased again during quarterly re-forecasts in H1 2007, as HBOS increasingly looked to the Corporate Division to make up for the underperformance of the Retail Division. In April 2007 the UPBT target was increased to 30%. In June 2007 the targets which Mr Cummings set for 2007 were adjusted to:

(1) UPBT growth of 35%; and

(2) lending growth of 10%.

4.60. In the light of the unresolved wide-ranging and serious issues in the business summarised at paragraphs 4.27 to 4.42 above, directing growth at these levels was imprudent.

4.61. By the end of July 2007, Corporate had generated 85% of the profits it made in the whole of 2006 and was 21% ahead of plan. Lending grew by 5% in this period.

4.62. Of particular note, in the first seven months of 2007:

(1) in relation to property, there was an 11% increase in lending;

(2) in relation to risk capital:

(a) the reported book value of Corporate's investment portfolio grew by 12%, despite strong realisations;

(b) Joint Ventures' UPBT was up by 373% on the same period in 2006, with the business having already made 82% of its planned profits for the full year; and

(c) ISAF's UPBT was up by 109% on the same period in 2006 and already in excess of plan for the full year.

(3) in relation to leveraged finance activity:

(a) there were 198 transactions in excess of £75 million, with a total value of £56.1 billion; and

(b) there were 61 transactions in excess of £250 million, with a total value of £37.7 billion.

(4) in relation to single name exposure, the total value of the top 30 exposures increased by 8% from the start of 2007 to the end of June 2007 (from £24.2 billion to £26.1 billion), increasing the proportion of these exposures to the overall Corporate portfolio from 17% to 22%.

4.63. The average credit quality of both new and renewal business remained significantly worse than the target risk rating.

4.64. The aggressive and high risk growth strategy which Mr Cummings directed the business to adopt contrasted with statements in the internal business plan for 2007/2011, which suggested that:

(1) the conservative approach to credit risk and the drive for improved credit quality would continue;

(2) the business would continue to sell down exposures to avoid a concentration of risk; and

(3) credit experience was expected to remain benign, reflecting the business' cautious hold appetite and preference for asset backed lending.

*Impact of the economic downturn*

4.65. There were indications in 2006 and 2007 that a peak of the economic cycle had been reached and that there was a risk of a downturn. Despite this, Mr Cummings continued to direct the Corporate Division to lend in a way that increased credit risk and concentration risk, thereby increasing the vulnerability of the portfolio to such a downturn. It was also clear to Mr Cummings that, in addition to the unresolved wide-ranging and serious issues in the business summarised at paragraphs 4.27 to 4.42 above, there were, as a result of the changed economic environment, serious issues with the effectiveness of the syndication/sell-down strategy, a key mitigant of risk.

4.66. The financial crisis had a significant market impact during the second half of 2007:

(1) in June 2007 there was speculation about the viability of two Bear Sterns hedge funds and their collapse was confirmed in July 2007;

(2) in August 2007 BNP Paribas announced that it had suspended a number of its funds due to liquidity issues; and

(3) in September 2007 the Bank of England announced that it had agreed to give emergency financial support to Northern Rock.

4.67. The impact of the financial crisis and the resulting economic downturn on the existing transactions within the Corporate Division's portfolio manifested itself in a number of ways:

(1) in relation to property, the downturn affected both the borrower's ability to service the debt and also the value of the underlying security;

(2) in relation to risk capital, the increased risk of default meant that the risks associated with these transactions, in particular the absence of security and the lower levels of control over assets, now became acute, as did the issues regarding conflicts of interest;

(3) in relation to leveraged finance, the increased risk of default meant that the potential impact of failure of these large transactions was substantial;

(4) in relation to significant large borrowers, the increased risk of default meant that the potential impact was substantial;

(5) to the extent that any existing deals had not yet been sold down to target hold levels, the underwriting risk had increased significantly; and

(6) the need for effective monitoring of existing transactions and the portfolio as a whole was of increased importance.

4.68. The impact on new transactions manifested itself in a number of ways:

(1) there was now an acute risk of syndication failure, particularly in underwriting highly leveraged deals with aggressive structures; and

(2) the need for a rigorous assessment of credit quality as part of the loan sanctioning process had become acute.

4.69. Despite these issues, Mr Cummings directed the Corporate Division to adopt a strategy of lending through the cycle. This strategy involved supporting existing customers (which in turn further increased the business's exposure to significant large borrowers) and actively seeking to increase market share. Significant volumes of new business continued to be sanctioned by the Corporate Division in this period.

4.70. Furthermore, despite the acute risk of syndication failure, Mr Cummings directed the Corporate Division to continue to lend despite the inability to syndicate the transactions. A number of large transactions were entered into notwithstanding the advice of Corporate's loans distribution unit and without any proper assessment of the increased risks arising from the potential correction in the syndication market. Mr Cummings was personally involved in sanctioning these transactions.

4.71. The impact of the financial crisis on the syndication market meant that there were severe constraints on the ability of the business to reduce its exposure at a time when there was an increasing risk of default. By 30 April 2008, the value of Corporate's loans waiting to be sold down was £9.7 billion.

4.72. In addition the average credit quality of both new and renewal business sanctioned across the Corporate Division remained low, and worse than the target portfolio, in the period August 2007 to March 2008.

*The growth of the business in the period August 2007 to March 2008*

4.73. From the start of this period Mr Cummings was aware or should have been aware that:

(1) there continued to be significant unresolved issues with the effectiveness of the control framework, which were exacerbated by issues in relation to culture and management information;

(2) the framework for the management of credit risk across the portfolio was still not robust; and

(3) the process for the identification and management of stressed transactions was still not operating effectively.

4.74. During this period:

(1) the full extent of the financial crisis and increased risk of a severe economic downturn became increasingly apparent;

(2) as a consequence, the risk of default increased significantly;

(3) the syndication market was effectively closed from 10 August 2007, which meant that Corporate was not able to reduce its exposure by selling down debt; and

(4) transactions within the portfolio began to exhibit signs of stress and the level of impairments began to increase.

4.75. Despite this, Mr Cummings continued to direct the business to focus on revenue generation and aggressive growth. He did not take reasonable steps to assess, manage or mitigate the potential risks of this strategy. Instead, Mr Cummings directed the Corporate Division to continue to strive to meet the challenging targets that had been set for 2007. He directed Corporate to seek to increase market share as other lenders were withdrawing from the market.

4.76. Directing growth at these levels was imprudent given the unresolved wide-ranging and serious issues in the business summarised at paragraphs 4.27 to 4.42 above. Furthermore directing growth at these levels was also imprudent given the changed economic environment.

4.77. In the full year 2007 (despite the less favourable economic environment in the last five months of the year), Corporate had achieved the following:

(1) UPBT growth of 32%. This was 7.5% above the original plan target and just £60 million short of the ambitious target of £2.4 billion set at the end of H1; and

(2) lending growth of 22%.

4.78. Of particular note:

(1) in relation to property, in the last five months of 2007, there was a 15% increase in lending;

(2) in relation to risk capital, in the last five months of 2007:

(a) the reported book value of Corporate's investment portfolio grew by 31%, with additions significantly outweighing disposals;

(b) Joint Ventures produced strong results contributing to UPBT results for the full year 2007 that were 107% up on 2006 and well in excess of plan;

(c) ISAF continued to produce strong results contributing to exceptional above plan UPBT results for the full year 2007 that were 73% up on 2006;

(3) in relation to leveraged finance activity, in the last five months of 2007:

(a) there were 163 transactions in excess of £75 million, with a total value of £40.2 billion;

(b) there were 49 transactions in excess of £250 million, with a total value of £26.3 billion; and

(4) in relation to single name exposure, the total value of the top 30 exposures increased by 19% from the start of July 2007[7] to the end of 2007 (from £27.9 billion to £33.2 billion), increasing the proportion of these exposures to the overall Corporate portfolio from 22% to 23%.

4.79. In the business plan for 2008/2012, Mr Cummings set the following targets for 2008:

(1) UPBT growth of 2.3%; and

(2) lending growth of 9.6%.

4.80. Given the financial crisis, this represented an extremely challenging target. In the light of the changed economic environment and the unresolved wide-ranging and

[7] These figures include Corporate-Europe exposures.

serious issues in the business summarised at paragraphs 4.27 to 4.42 above, further growth at this point was imprudent.

4.81. Mr Cummings directed the business to continue to lend in the first three months of 2008 as the risk of a severe downturn intensified. He did not take reasonable steps to assess, manage or mitigate the potential risks of this strategy.

4.82. During Q1 2008:

(1) In relation to property, there was a 4% increase in lending;

(2) In relation to risk capital:

(a) the reported book value of Corporate's investment portfolio grew by a further 10%, with additions outweighing disposals;

(b) Joint Venture's UPBT was positive (albeit behind plan);

(c) ISAF's UPBT was positive (albeit behind plan).

(3) In relation to leveraged finance activity;

(a) there were 46 transactions in excess of £75 million, with a total value of £11.6 billion;

(b) there were 11 transactions in excess of £250 million, with a total value of £7.1 billion; and

(4) In relation to single name exposures the total value of the top 30 exposures increased by 3% (from £33.2 billion to £34.1 billion), maintaining the proportion of these exposures to the overall Corporate portfolio at 23%.

4.83. The average credit quality of both new and renewal business remained significantly worse than the target risk rating throughout this period.

4.84. Despite the aggressive and high risk growth strategy which Mr Cummings directed the business to adopt, he stated in the internal business plan for 2008/2012 that:

(1) the strategy of measured lending growth and sound credit quality would continue;

(2) the conservative approach to credit risk management would continue;

(3) a more conservative approach would be taken to single large exposures until the markets normalised; and

(4) there would be aggressive sell down of exposure to leveraged finance deals.

**Mr Cummings' failings in the period January 2006 to March 2008**

*Summary*

4.85. Between January 2006 and March 2008, the Corporate Division, under Mr Cummings' direction, pursued an aggressive growth strategy, the effect of which was to increase the risk profile of a business which was already focussed on high-risk, sub-investment grade lending. He did so despite known weaknesses in the control framework, which meant that it failed to provide robust oversight and challenge to the business. Further, he continued to do so as market conditions began to worsen in the course of 2007. He did not take reasonable steps to assess, manage or mitigate the risks involved in the aggressive growth strategy.

*2006*

4.86. At the outset of his appointment in January 2006, Mr Cummings understood the high risk profile of the business. He was also aware or should have been aware that:

(1) There were indications that the economic cycle was at or reaching a peak;

(2) competitive pressures in the leveraged finance market were having a negative impact on deal structures and increasing underwriting risk.

4.87. Given the high level of risk and exposure to the economic cycle in the portfolio, the effective assessment, management and mitigation of credit risk required the following:

(1) an effective control framework for the sanctioning and monitoring of individual transactions;

(2) an effective framework for the management of credit risk across the portfolio as a whole;

(3) an effective framework for the distribution of risk through sell-down, by syndication or other means;

(4) an effective process for the prompt identification and management of transactions which showed signs of stress;

(5) a culture which gave due weight to credit risk management; and

(6) reliable management information.

4.88. However, as Mr Cummings was aware or should have been aware, during the Relevant Period:

(1) there were serious deficiencies in the control framework, which meant that it failed to provide robust oversight and challenge to the business;

(2) there were serious deficiencies in the framework for the management of credit risk across the portfolio which meant that there was a lack of focus on the need to manage risk across the portfolio as a whole;

(3) there were serious deficiencies in the distribution framework which meant that it did not operate effectively to reduce the risk in the portfolio;

(4) there were serious deficiencies in the process for the identification and management of transactions which showed signs of stress which meant that they were neither identified promptly nor managed effectively; and

(5) these issues were exacerbated by significant issues in relation to culture and management information.

4.89. Mr Cummings had particular concerns over transparency, lending practices and controls in specific areas of the business, including Real Estate and Joint Ventures.

Mr Cummings understood or should have understood that the available management information was not capable of giving a reliable view of the degree of risk in these areas or the portfolio as a whole.

4.90. These serious issues meant that there was a high degree of risk associated with maintaining existing levels of business (particularly given the high rate of portfolio turnover required to do so) during 2006. As a consequence, on his appointment in January 2006 and pending the resolution of these issues Mr Cummings should have:

(1) taken immediate steps to improve the credit quality of the portfolio, focussing on the areas where his concerns were greatest. Such steps could have included restricting origination activity by setting and enforcing more specific risk parameters and/or reducing concentration risk; and

(2) ensured that the targets that had been set in relation to UPBT and asset growth for the business were prudent.

4.91. Mr Cummings failed to take these steps. Instead he directed the Corporate Division to pursue an aggressive growth strategy, in pursuit of which it entered into transactions of increasing size, complexity and downside risk. This had the effect of increasing the already high level of risk and exposure to the economic cycle in the portfolio at a time when Mr Cummings recognised, or should have recognised, that there were indications that the economic cycle was at or near a peak. This was not a prudent approach.

4.92. Having directed Corporate to pursue the growth targets at the start of 2006, Mr Cummings should have acted prudently in directing and managing the growth of the business. For example, he should have:

(1) clearly articulated to the Group the risks associated with the growth targets and the impact on the stated risk appetite, in particular in relation to concentrations in commercial property, risk capital and leveraged finance;

(2) ensured that appropriate parameters were set whereby the levels of exposure to commercial property, risk capital and leveraged finance could be effectively

monitored and controlled in order to comply with the stated policy of conservatism and improved credit quality;

(3) ensured that the loans distribution framework was reorganised to ensure that transactions were priced and structured so as to facilitate sell-down;

(4) identified that the specific risks applicable to risk capital would require specific controls, oversight and management, in the absence of which a 'one-stop-shop' approach was not prudent; and

(5) acted prudently in revising targets for 2006 during quarterly re-forecasts, and in the business planning process for 2007.

*January to July 2007*

4.93. By January 2007, Mr Cummings understood or should have understood that the issues identified at paragraphs 4.27 to 4.42 above had not been adequately resolved because the projects, which he had initiated, had not yet produced their desired outcomes. Mr Cummings also understood or should have understood that the effect of the aggressive growth during 2006 had been to increase the level of risk in the portfolio. Additionally there were further indications that the economic cycle was reaching a peak.

4.94. These serious issues meant that there was a high degree of risk associated with maintaining the levels of business that the Corporate Division had originated in achieving above plan growth in 2006 (particularly given the high rate of portfolio turnover required to do so). As a consequence, pending the resolution of these issues Mr Cummings should have:

(1) taken immediate steps to improve the credit quality of the portfolio, focussing on the areas where his concerns were greatest. Such steps could have included restricting origination activity by setting and enforcing more specific risk parameters and/or reducing concentration risk; and

(2) acted prudently in setting UPBT and asset growth targets for the business

4.95. Mr Cummings failed to take these steps. Instead, having increased the profit growth target for 2007 from 10-12% to 22% in the course of the Group challenge process, he agreed further increases to 30% in April 2007 and 35% in June 2007. This was not prudent, particularly in the light of the increased concerns being expressed within HBOS as to the leveraged finance market around that time.

4.96. Having directed Corporate to pursue the growth targets in business planning for 2007, Mr Cummings should have acted prudently in directing and managing the growth of the business. For example, he could have:

(1) clearly articulated to the Group the risks associated with the growth targets and the impact on the stated risk appetite, in particular in relation to concentrations in commercial property, risk capital and leveraged finance;

(2) ensured that appropriate parameters were set whereby the levels of exposure to commercial property, risk capital and leveraged finance could be effectively monitored and controlled in order to comply with the stated policy of conservatism and improved credit quality;

(3) ensured that the loans distribution framework was reorganised to ensure that transactions were priced and structured so as to facilitate sell-down;

(4) identified that the specific risks applicable to risk capital would require specific controls, oversight and management, in the absence of which a 'one-stop-shop' approach was not prudent; and

(5) acted prudently in revising targets for 2007 during quarterly re-forecasts.

*August 2007 to March 2008*

4.97. By the end of August 2007, Mr Cummings understood or should have understood that:

(1) the issues identified at paragraphs 4.27 to 4.42 above had not thus far been resolved;

(2) the effect of the aggressive growth during the first seven months of 2007 had been to increase the level of risk in the portfolio;

(3) the syndication market was effectively closed, particularly to aggressively structured deals; and

(4) peers were withdrawing from the market.

4.98. Mr Cummings should have acted prudently in responding to the changed economic environment. For example, he could have:

(1) ensured that clear parameters were set for the level of exposure to underwriting on a unilateral basis to reflect the closure of the syndication markets and ensured that a clear pricing strategy was in place;

(2) ensured that existing risk parameters were reviewed to ensure that they were still appropriate to monitor effectively and control the level of exposure in order to comply with the stated policy of conservatism and improved credit quality;

(3) ensured that the business devoted greater resource and attention to monitoring the performance of existing assets on the Corporate book; and

(4) ensured that the changed economic environment was better accounted for during the business planning process for 2008.

*Conclusion*

4.99. These failings constitute a failure by Mr Cummings to act with due skill, care and diligence and hence a failure to discharge his regulatory obligations.

**Approach to stressed transactions**

*Slow migration to High Risk*

4.100. It was the responsibility of the relevant business area to identify a particular transaction as stressed and to refer that transaction to the High Risk team. The High Risk team would then carry out a detailed assessment of the transaction's credit risk, re-rating the transaction as required. Following that assessment, the transaction would either be returned to the good book, classified as High Risk, classified as Impaired No Loss or classified as Impaired with Loss. Where appropriate, a provision would then be made.

4.101. However, throughout the Relevant Period:

(1) the weaknesses in the control framework meant that the identification of potential or actual default (e.g. through the monitoring of covenants) was slower than it should have been;

(2) the culture of optimism meant that, even when potential or actual default had been identified, the business area was slower than it should have been in referring the transaction to High Risk; and

(3) High Risk was insufficiently resourced and the management information available to it was unreliable.

4.102. Mr Cummings was aware or should have been aware of these issues from the beginning of the Relevant Period and they were highlighted to him as outstanding matters of concern in a number of control reports issued throughout the Relevant Period.

4.103. As a consequence, the process for the identification and management of transactions which showed signs of stress was not effective throughout the Relevant Period. This directly impeded the ability of the business to assess, manage and mitigate credit risk.

4.104. In the market environment which existed during the period from August 2007 to March 2008, the need for a rigorous approach to the identification and management of stressed transactions within the portfolio had become acute.

4.105. By April 2008, the scale of the financial crisis and its impact on the Corporate Division's markets was recognised within HBOS. By April 2008, the unresolved issues in relation to the control framework and the high risk profile of the business meant that the risk of stress and the likelihood of default and impairment were now very high. From this time, it became acutely important for Mr Cummings to acknowledge the impact of the financial crisis on the Corporate Division and to take proactive steps to understand the nature and extent of any stressed assets, ensuring that they were promptly migrated to the High Risk and Impaired Assets team.

4.106. As noted at paragraph 4.100 above, it was the responsibility of the relevant business area to identify a particular transaction as stressed and to refer that transaction to the High Risk team. However, throughout the Relevant Period the migration of stressed assets to the High Risk team was consistently too slow. As Mr Cummings was aware, the pace of migration was still a significant issue as late as December 2008.

4.107. It is accepted that a degree of management judgment is necessarily involved in the assessment of credit quality and risk. It is also accepted that the severity of the downturn was not fully foreseen. However, the vulnerability of the business to the downturn was a direct result of the high risk lending strategy which the Corporate Division had pursued under Mr Cummings' direction.

4.108. Mr Cummings knew that the available management information was not sufficient for the purpose of conducting an effective assessment of the portfolio. He also knew or should have known that the culture of optimism had engendered a reluctance to refer stressed transactions to the High Risk team. Accordingly, Mr Cummings knew, or should have known, that there was a significant risk that the full extent of impairment would not have been identified.

4.109. There was a failure within the Corporate Division to recognise and accept the impact of the financial crisis on the portfolio. The culture of optimism which pervaded the business impeded the identification and effective management of transactions as they became stressed and delayed the referral of stressed transactions to the High Risk team. There was a significant risk that this would have an impact on HBOS's capital requirements. It also meant that the full extent of stress in the Corporate portfolio was not sufficiently visible to the Group, auditors and regulators.

4.110. Mr Cummings personally demonstrated a significant and unreasonable degree of optimism regarding the credit quality and risk profile of the portfolio throughout the period April to December 2008.

4.111. It should have been apparent to Mr Cummings that a more prudent approach was now essential in order to mitigate the high degree of risk facing the business. However, Mr Cummings did not adopt such an approach.

*Impact on impairments and provisioning*

4.112. There was a significant risk that the failings listed above at 4.101 would affect the timing and scale of impairments recognised and provisions made for Corporate in HBOS's financial statements. The culture of optimism also meant that, once a transaction had been referred to High Risk, the assessment of the level of individual provisions was consistently optimistic rather than prudent. Mr Cummings did not follow the approach to levels of provisioning which had been suggested by HBOS's auditors and the Corporate Division's Risk function.

4.113. In the period April to December 2008, HBOS made a number of public statements as to the level of impaired assets within the Corporate Division's portfolio and the level of provisions which had been made:

(1) on 19 June 2008, HBOS issued a prospectus in relation to a rights issue. Corporate's year-to-date impairment losses were not quantified or commented on in the prospectus. Management information indicated that, as at 31 May 2008, it had year-to-date impairment losses of £369.9 million;

(2) on 31 July 2008, HBOS published its interim results. This included details of the financial statements as at 30 June 2008 and stated that, as at 30 June 2008, there were year-to-date impairment losses of £469 million;

(3) on 18 November 2008, HBOS issued a prospectus in relation to a placing and open offer. This included details of the financial statements as at 31 October 2008 and stated that, as at 30 September 2008, there were year-to-date impairment losses of £1.7 billion; and

(4) on 12 December 2008, HBOS published a Trading Update. This included details of the financial statements as at 30 November 2008 and stated that, as at 30 November 2008, there were year-to-date impairment losses of £3.3 billion.

4.114. Throughout this period, HBOS's auditors KPMG agreed that the overall level of its provisioning was acceptable. However, in relation to Corporate, they suggested that a more prudent approach would be to increase the level of provision by a significant amount. Mr Cummings (and other members of the HBOS senior management team) chose to provision at what KPMG identified as being the optimistic end of the acceptable range for Corporate. KPMG's view of what constituted the acceptable range was informed by management's assessment (including the personal assessment of Mr Cummings) of the degree of credit risk in particular transactions. Further, as explained at paragraph 4.109, the slow migration to High Risk meant that the full extent of stress in Corporate's portfolio was not sufficiently visible to KPMG.

4.115. Further, during the Relevant Period Corporate Division's Risk function also suggested that a more prudent approach would be to increase the level of provision by a significant amount. Mr Cummings (and other members of the HBOS senior management team) did not follow this advice. For example, in December 2008, the Corporate Risk function identified a range of between £4.5 billion and £6.4 billion for provisioning to year end. The Corporate Risk function stated that their view was not to provision at the lower end of this £2 billion range, given the likely impact of deteriorating economic conditions on the transactions they had assessed and the anticipated migration from the good book of other transactions. They thus suggested that provisions should be taken at a higher level. However, Mr Cummings (and other members of the HBOS senior management team) adopted a different approach, setting the provision at the lowest end of this £2 billion range.

4.116. The December 2008 Management Accounts issued by HBOS had assessed Corporate's year-to-date impairment losses as at 31 December 2008 as £4.7 billion. On 16 January 2009, Lloyds completed its take-over of HBOS (in the course of which the UK government through HM Treasury acquired approximately 43.4% of the enlarged ordinary share capital of Lloyds). On 13 February 2009, Lloyds issued a trading update for the year ended 31 December 2008 which noted, in respect of the Corporate Division, that:

(1) year-to-date impairment losses as at 31 December 2008 were now assessed at approximately £7 billion;

(2) this revised assessment was as a result of:

(a) the application of a more conservative provisioning methodology; and

(b) the acceleration in the deterioration in the economy.

4.117. On 27 February 2009, Lloyds issued HBOS's preliminary results for 2008. This confirmed the impairment losses in Corporate as £6.7 billion and stated that the following impairment losses had been established:

(1) Real Estate: £1.6 billion

(2) Joint Ventures: £1.3 billion

(3) ISAF: £0.9 billion.

4.118. These impairment amounts were substantially higher (approximately £2 billion) than the equivalent amounts accounted for by HBOS. This difference was attributable to the following:

(1) the level of Corporate's exposure to property;

(2) pronounced falls in property values and other investments had also resulted in substantial losses from the investment portfolio, primarily in Joint Ventures and ISAF;

(3) the shape of the Corporate book and in particular its exposure to house builders, risk capital and large single credit exposures, which exacerbated the impact of the economic downturn. Property-related sectors accounted for around 60% of the individual impairment provisions; and

(4) the Corporate Division's credit risk management had been unable to react quickly enough to contain the severe economic deterioration in the second half of 2008. This had been exacerbated by the Firm's historic levels of exposure concentration within property-related sectors and had resulted in a dramatic increase in impairment losses.

4.119. The substantial increase in impairment losses reflected, in part, economic conditions. However, it also reflected the imposition of more prudent and robust risk management and impairment policies and methodology. As noted at paragraph 4.115 above, Corporate Risk had recommended provisioning of up to approximately £6.4 billion in December 2008.

**Mr Cummings' failings in the period April to December 2008**

*Summary*

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

*Slow migration to High Risk*

4.121. By April 2008 it was apparent to Mr Cummings that a number of high value transactions had begun to demonstrate signs of stress and that this was likely to worsen over the course of 2008. However, as Mr Cummings was aware, transactions were consistently moved too late to the High Risk area of the Corporate Division. This delayed the assessment of transactions to determine whether they should be formally classified as stressed or impaired. There was a significant risk that this would have an impact on the Firm's capital requirements. It also meant the full extent of stress in the Corporate portfolio was not sufficiently visible to others in HBOS, auditors and regulators.

4.122. Given Mr Cummings' knowledge of the scale of this issue, from April 2008 he should have taken proactive steps to ensure that high value transactions on the Corporate book were assessed in detail for signs of stress and appropriately classified. It was particularly important that he did this ahead of the public disclosures referred to at paragraph 4.113 above. For example, he could have:

(1) clearly articulated to staff the need to adopt a conservative and prudent approach and to devote greater resource and attention to rigorous close monitoring of transactions on the book, reinforcing the importance of the prompt migration of any transactions showing signs of stress to High Risk;

(2) clearly articulated to management the need to prioritise effective oversight and supervision of this process;

(3) ensured that the criteria for referral to High Risk were reviewed to ensure that they were clear, appropriate and understood by the business; and

(4) ensured that the High Risk team was appropriately resourced.

4.123. However, he failed to do this, permitting the culture of optimism to impede the effective management of transactions as they became stressed.

*Impact on impairments and provisioning*

4.124. There was a significant risk that these failings would affect the timing and scale of impairments recognised and provisions made for Corporate in the Firm's financial statements. Whilst the FSA makes no findings regarding the accuracy of the Firm's financial statements, Mr Cummings should have taken a more prudent approach to the levels of impairment and provisioning for Corporate. However, provisions were made at the lower end of the range given by the divisional Risk function and the Firm's auditors. In the period April to December 2008, the Firm made a number of public statements as to the level of impaired assets within the Corporate Division's portfolio and the level of provisions which had been made. On 13 February 2009 Lloyds Banking Group[8] announced that significant additional impairments had been required on Corporate's lending portfolios in the light of the application of a more conservative recognition of risk and the further deterioration in the economic environment. The level of impairment that was recognised, was increased from £3.3 billion to approximately £7 billion.

*Conclusion*

4.125. These failings to act prudently constitute a failure by Mr Cummings to act with due skill, care and diligence and hence a failure to discharge his regulatory obligations.

[8] Lloyds Banking Group completed its take-over of HBOS on 16 January 2009.

# 5. REPRESENTATIONS, FINDINGS AND CONCLUSIONS

## Representations

5.1. Mr Cummings made written and oral representations in which he submitted that his conduct had not fallen below the requisite regulatory standards. Mr Cummings further contended that the FSA was wrong to draw the conclusions which it did from the evidence and that the analysis which had been performed by the FSA was unfairly and improperly dependent upon hindsight.

5.2. Below is a brief summary of the key written and oral representations made by Mr Cummings and how they have been dealt with. In making the decision which gave rise to the obligation to give this notice, the FSA has taken into account all of Mr Cummings' representations, whether or not set out below.

*The decision to bring action against Mr Cummings alone*

5.3. Mr Cummings complained that it seemed inherently unfair that he was the only individual to face disciplinary action for conduct which would be perceived as having caused the failure of HBOS. He also complained that it was unfair that he was the only individual to face disciplinary action for conduct which might be perceived as having contributed to the financial crisis. Despite having made these complaints he also accepted that this alleged unfairness did not prevent the FSA from bringing disciplinary action against him alone. Instead Mr Cummings submitted that because the FSA's Enforcement and Financial Crime Division ("EFCD") had decided to focus upon him the action had become infected with unfairness. Mr Cummings submitted that the decision to focus upon him had created pressure to ensure that there was an outcome against him regardless of the evidence. In essence he submitted that the matter had been pre-judged as soon as EFCD had taken the decision to investigate him alone.

*The test to be applied when assessing Mr Cummings' conduct*

5.4. Mr Cummings submitted that the appropriate test to be applied when assessing whether or not his conduct had fallen below the appropriate standard was that which was set out in the recent report prepared by the FSA into the failure of Royal Bank of

Scotland. Mr Cummings characterised this test as being comprised of 3 stringent conditions which have to be satisfied before action can be taken against a member of the senior management at a bank which had encountered financial difficulties such as HBOS. He added that further support for his submission could be found in the judgment of the Upper Tribunal in the case of John Pottage v FSA ("the Pottage case").

5.5. The first condition for disciplinary action, in Mr Cummings submission, was that he could not be found to have committed regulatory breaches on a strict liability basis. He submitted that this was made clear in the RBS report and was also confirmed in the Upper Tribunal's judgment in the Pottage case. Mr Cummings submitted that it was not sufficient to say that, regardless of whether or not he had engaged in any misconduct, he was personally liable for the failure of HBOS simply because of the positions he had held. He further submitted that, even if it were concluded that he was responsible for the severe financial difficulties at HBOS, he could not be found to have committed a regulatory breach on that basis alone. Instead he stated that it was important to draw a distinction between responsibility and fault. He argued that, because the case against him could only succeed if he was shown to have been at fault, the case therefore failed. This was because the FSA's case was reliant upon his overall responsibility for the failings at Corporate resulting from his responsibility for the first line of defence.

5.6. The second condition in Mr Cummings' submission was that to demonstrate that he had committed regulatory breaches it had to be shown that his conduct had been unreasonable. He suggested that this test of unreasonableness was "set at a very high level". Mr Cummings submitted that the case against him failed because it did not meet the very high threshold required to demonstrate that any of his business judgements had been unreasonable. He contended that to demonstrate that his actions had fallen below the required regulatory standard it would be necessary to show that his decisions were "beyond the range of plausible judgement". He further submitted that the appropriate level of unreasonableness should be equated with conduct that could be defined as being irrational or evidently irresponsible.

5.7. The third condition, which Mr Cummings' submitted had to be met before action could be taken against him or others in a similar position, was that there should be very clear evidence to support the allegations. Mr Cummings submitted that the FSA had to apply the correct burden and standard of proof. He submitted that the allegations could only be made out if the FSA could prove conclusively that he had engaged in the alleged misconduct. He submitted that in the case against him there was a notable lack of compelling evidence providing conclusive proof that he had engaged in the alleged misconduct. In particular he noted that the FSA had not put forward "expert evidence which addressed the personal culpability of Mr Cummings". He submitted that though there is an automatic right of referral to the Upper Tribunal the FSA is still obliged to reach a reasoned decision which is correct in law. The FSA can not seek to apply lower and unlawful standards when making a decision, on the basis that the subjects of disciplinary proceedings can refer to the Tribunal. He thus submitted that the onus was on the FSA to only make a finding against Mr Cummings where there was conclusive proof that he had engaged in the alleged misconduct.

*The danger of considering aspects of Mr Cummings' conduct in isolation*

5.8. Having outlined what he considered to be the correct test to be applied in this case, Mr Cummings then addressed the breadth of the evidence which should be taken into account when assessing how his conduct measured up to the appropriate standards. In particular Mr Cummings submitted that when determining his case due regard should be given to everything he did in the Relevant Period and not simply to that which had been highlighted as evidencing his misconduct. To consider only that which had been selectively chosen to make the case against him would exclude from consideration the positive steps which Mr Cummings had taken to improve risk management.

5.9. Mr Cummings submitted that as the case was particularly focussed upon the reasonableness of his conduct when managing credit risk then it was necessary to assess the entirety of his conduct in this area. This would include the positive steps he had taken to improve the risk management framework. Mr Cummings further submitted that it was wrong to assert that there was a culture which he had helped cultivate within Corporate that regarded risk management as a constraint upon the business. He argued that the steps which he had taken and the attitude which this demonstrated towards the management of risk provided clear evidence to contradict such an assertion. Mr Cummings thus concluded that the assessment that had been made of the reasonableness of his conduct was necessarily flawed because significant issues such as his work in relation to the implementation of Basel II had been ignored.

*Mr Cummings' approach to risk management*

5.10. Mr Cummings submitted that the evidence demonstrated that he had endeavoured to make the management of risk central to all that the Corporate Division did. Moreover he highlighted documents which he submitted were clear support for his assertion that he had made the "embedding of Basel II" the most high priority goal for the division. Mr Cummings also criticised the FSA for failing to put forward expert evidence which had covered the steps he had taken to implement Basel II. He therefore submitted that it was extraordinary to suggest that he had regarded, or that he had encouraged others to regard, risk management as a constraint on the business. Instead he had embarked upon a variety of initiatives to ensure that the management of risk was integral to the business and that the risk function within Corporate was better aligned with the 'asset class strategy' which he had implemented.

5.11. Mr Cummings then questioned whether it was appropriate to criticise his conduct now, when during the Relevant Period the approach taken to risk management at Corporate had been endorsed by the FSA. He noted that his prioritisation of the implementation of Basel II accorded with what had been advocated by the FSA. Furthermore he submitted that the FSA had recognised at the relevant time that the implementation of Basel II was an ongoing process with refinements and developments being made in areas such as stress testing in the course of this process. He therefore argued that his conduct was evidently reasonable and prudent. He further submitted that the fact that matters were being improved did not necessarily mean that they were not fit for purpose at the outset.

5.12. Mr Cummings stated that the FSA had not made explicit any concerns it may have had about his approach to risk management or about the fact that the firm was continuing to lend when improvements were still being implemented. He submitted that if the FSA had such misgivings that it would be reasonable to assume that they would have made these concerns clear, particularly as the FSA had paid particular attention to this issue when supervising the firm. Therefore, he contended, it should be inferred that the FSA, which had been fully aware of matters such as the concentration of the Corporate portfolio, had approved of his approach to risk management throughout the Relevant Period. Thus it should be concluded that his conduct had been reasonable.

*Corporate Division's strategy*

5.13. Mr Cummings conceded that hindsight suggested that Corporate had adopted the wrong strategy. However he asserted that at the time that this decision to increase growth had been taken it had not been unreasonable for this strategy to have been adopted. In particular he submitted that in the light of what was reasonably assumed about the direction of the economy the strategy was not unreasonable. He also submitted that he had considered that the controls in place at Corporate were sufficient for such a strategy to have been successfully implemented.

5.14. Mr Cummings then disputed that it could be inferred that the growth targets were imprudently aggressive from the fact that Corporate's targets had been subject to significant upwards revisions following the Group challenge process. He submitted that despite the upwards revision of these targets it was still not unreasonable to have adopted this growth strategy in the light of the economic conditions, as they were then perceived.

5.15. Mr Cummings also noted that the revision of the growth targets following the Group challenge process demonstrated that he had not been solely responsible for the adoption of these growth targets. He explained that these targets were reached following extensive and appropriate discussions concerning matters such as the risks of growth. He thus asserted that it was wrong to suggest that he had personally directed the growth strategy. He suggested that instead the proper way to characterise his conduct would be to say that he had implemented a plan agreed upon by the Group Board.

*The economic outlook and the unforeseen severity and speed of the crisis*

5.16. Mr Cummings submitted that when assessing the reasonableness of his conduct it was also important to consider his conduct in the context of what was predicted for the economy and what he could reasonably be expected to have foreseen. He explained that throughout much of the Relevant Period it was commonplace and thus not unreasonable to hold an optimistic view of the economic outlook. Mr Cummings noted that internal and external advice at HBOS also supported this positive assessment of the economy. He noted by way of example that in September 2006 it was suggested that the economy was at a relatively benign point of the cycle. This positive view at the Group level was echoed in the advice that he received in Corporate. In particular Mr Cummings noted that in February 2007 it had been suggested that there would be positive UK growth for at least 2 years. Mr Cummings also highlighted the FSA’s acknowledgement in the RBS report that it was not unreasonable to have failed to predict the severity of the economic downturn.

5.17. Mr Cummings thus disputed the suggestion that a downturn had been foreseeable from the start of the Relevant Period. Instead he asserted that his conduct could not be considered to be unreasonable particularly when the positive view of the economic outlook which had prevailed throughout much of the Relevant Period had been echoed by the FSA.

5.18. Mr Cummings also submitted that the financial crisis was so severe and worsened with such speed that it was not realistic to have expected him to have planned for such an event. He asserted that the problems which beset HBOS only arose because of the speed and severity of the financial crisis. He argued that had HBOS faced a more predictable downturn then it would not have failed and disciplinary action would not have been brought against him.

*The alleged failings in the systems and controls*

5.19. Mr Cummings submitted that the fact that he had initiated a variety of projects to improve the control framework and the approach to risk management did not mean that the systems and controls which were already in place were necessarily inadequate or that he perceived them to be inadequate. He submitted that though he perceived that these systems and controls could be improved he did not consider that they fell below the requisite standards.

5.20. Mr Cummings commented that it was notable that during the Relevant Period the FSA had not complained about the systems and controls within the Corporate Division. He submitted that if the systems at Corporate were then so inadequate as to have been below the relevant regulatory standards, then the FSA should have expressed that view at the time. He argued that the fact that the FSA had not complained at the time was strong evidence to suggest that even to the independent observer the systems and controls at Corporate appeared to be suitably robust.

5.21. Mr Cummings noted that there had been an incident involving misconduct which had gone undetected for a number of years. However, Mr Cummings asserted that this incident, which he categorised as an operational risk rather than a credit risk, did not demonstrate any failings in the controls within Corporate. It was as a result of the changes he had instigated to asset class management that this misconduct had been discovered. Furthermore, he argued that as a consequence of the discovery of this incident the control environment was made more robust.

5.22. Mr Cummings thus submitted that the FSA was wrong to suggest that there were serious deficiencies in: the control framework; the management of credit risk; the distribution framework; and the management of stressed transactions. He also submitted that to the extent that there were any deficiencies in any of these areas they were not such as to merit the current regulatory action.

*The implementation of the growth strategy*

5.23. Mr Cummings submitted that he perceived that there were adequate and sufficient systems and controls in place. Therefore it was not unreasonable for Corporate to have implemented the strategy designed to meet the growth targets set for the division. Moreover he argued that when efforts were made to grow the business this was done in a managed way. He submitted that the evidence demonstrated that he and others oversaw the lending and continually monitored the risks inherent to this credit. He argued that whilst the portfolio risk rating had regularly been either 6.1 or 6.2 (which was below the “target” figure of 5.2) this was not indicative of any failing at Corporate. He submitted that the 5.2 figure had been, at most, an 'aspirational' figure but it had not been a target which they had focussed upon attempting to meet. Instead, he contended, the risk rating of the portfolio had remained at a stable and manageable level.

5.24. In the light of the foregoing Mr Cummings submitted that Corporate had not engaged in imprudent lending. Instead he argued that each transaction, whether it was higher or lower risk, was part of a broader and reasonable strategy. Furthermore he argued that the individual large transactions, which carried with them the greatest levels of concentration risk, were only entered into following a robust approval process.

5.25. Mr Cummings noted that he had been personally involved with the larger transactions. However he asserted that culpability for the stress that some of these assets endured should not be imputed to him because of this involvement. He submitted that these lending decisions had been taken by him acting with others in committee. Furthermore he submitted that these lending decisions were reasonably made and that it was only during the financial crisis that they became the wrong business to have engaged in.

5.26. Mr Cummings also disputed that he had not acted prudently when the markets began to worsen. He asserted that Corporate had 'reined back' following August 2007 from the previous growth strategy which had been pursued. However he explained that Corporate had not stopped all lending as to have done so would have been imprudent as it would have conveyed the wrong message to the markets and this would have promoted a crisis.

*Migration of stressed assets*

5.27. Mr Cummings queried the evidential basis for the allegations made against him concerning the management of Corporate's stressed assets. He submitted that the evidence actually indicated that in the Relevant Period it was felt that there was a proper control of the migration of high risk stressed assets. He conceded that it was apparent with the benefit of hindsight that the migration of stressed assets could have been improved. However he submitted that the procedures in place were not deficient and certainly not so deficient that they evidenced a breach of the regulatory standards.

Instead he submitted that problems in the migration of stressed assets only manifested themselves after June 2008 when it became impossible to keep up with the rapid deterioration in the markets.

5.28. Though he insisted that the process for the identification and management of stressed assets was adequate, Mr Cummings did accept that it was now apparent that there were structural failings in the management of stressed assets. However he disputed that there were disincentives to the migration of impaired assets. Instead he insisted that the evidence demonstrated that there were no disincentives to the prompt migration of stressed assets though he accepted that in practice some relationship managers had not promptly referred impaired assets to the High Risk team.

5.29. Furthermore Mr Cummings submitted that in assessing his conduct in relation to the management of stressed transactions it was also important to bear in mind that he was not directly involved in this area. Instead he asserted that his responsibility was to exercise proper oversight in this area which he submitted that he had done. He noted, in support of this contention, that he had replaced the individual with specific responsibility for management of stressed assets. He also submitted that he had been appropriately informed of how the system was operating and the information which he was given suggested that the system was operating effectively and that it was reasonably robust. He conceded that the financial crisis had exposed the fact that there were structural control failings in relation to the migration of stressed assets. However he submitted that these were not evident to him and that it was unreasonable to have expected him to have known of these flaws in the system. He therefore argued that he had not been in breach of his general duty of oversight in relation to the migration of impaired assets.

*Provisioning*

5.30. Mr Cummings explained that the unprecedented scale and speed of the financial crisis led to a rapid credit deterioration. He added that the provisions which had been made at Corporate were not sufficient to cope with this credit deterioration. However, notwithstanding the problems which arose as a result of the level of provisions, he submitted that he should not be held to be personally culpable for the lack of provision for the losses which HBOS eventually incurred.

5.31. Mr Cummings submitted that the decisions concerning provisioning were not taken by him alone and he had limited responsibility for this area. Additionally he also submitted that in any event the decisions which were taken as to the appropriate levels of provision were reasonable ones. Mr Cummings submitted that none of those who had reviewed the level of provisioning had regarded it as imprudent and therefore he submitted that it was unfair to suggest, with the benefit of hindsight, that Corporate in the Relevant Period had adopted an unreasonable stance towards the appropriate level of provision.

*Mr Cummings' responsibility*

5.32. Mr Cummings submitted that his responsibility had to be considered in the context of the involvement of others in the decisions which were central to the allegations against him. He submitted that it was clear from the Pottage case that his role was one of oversight. He was not personally responsible for the design, creation or implementation of controls nor was he to do the job of an appropriately appointed delegate. Instead the obligation on him was to take reasonable steps to ensure that the business had compliant systems and controls. He thus submitted that he had discharged his regulatory obligations and that the FSA's action against him should be discontinued as he was no more at fault than other approved persons at HBOS.

5.33. Mr Cummings submitted that throughout the Relevant Period he had reasonably placed reliance upon others such as Group Risk and Corporate's risk function. He also noted that decisions such as those concerning significant transactions were made in committee. He argued that all of the decisions had been taken in a 'proper collegiate way' and in accordance with appropriate governance arrangements. He therefore submitted that he should not be found to be solely responsible and consequently culpable for decisions which had only been impugned because of the financial crisis. In making the foregoing submissions Mr Cummings accepted that they did not mean that simply because he was not solely responsible for various relevant aspects of the management of Corporate then he could not be found to be culpable for any of the alleged failings within the division.

5.34. Mr Cummings additionally submitted that in assessing his personal culpability for any of the alleged failings within the Corporate division the FSA should take into account the reasonable reliance which he placed upon the information he received from others within Corporate. Mr Cummings submitted that it was clear from the Pottage case that he was entitled to place reasonable reliance upon what he was told.

5.35. Mr Cummings also submitted that it was wrong for the FSA to bring action against him when its case was reliant upon the fact that Mr Cummings had initiated a number of projects designed to change and improve systems and controls within Corporate. He argued that by bringing this disciplinary action the FSA was condemning him for being a vocal advocate for change. He submitted that a significant consequence of this disciplinary action would be to discourage others from engaging in similar change programmes even if, as here, they were simply trying to improve that which was already adequate.

*Sanctions*

5.36. In addition to the foregoing submissions which were concerned with culpability Mr Cummings also put forward submissions about the financial penalty. Mr Cummings submitted that the FSA should ensure, when considering whether to impose a financial penalty (and the appropriate level of any such financial penalty), that no disparity should arise between Mr Cummings and other similar cases. In particular Mr Cummings submitted that the fine was far higher than in other comparable cases involving similar allegations against significant influence function holders. Furthermore Mr Cummings also highlighted the contrast between the financial penalty that was being imposed upon him and the public censure imposed upon HBOS.

5.37. Mr Cummings also submitted that regardless of the comparator cases the financial penalty was too high in the specific circumstances of his case. He argued that his conduct in this matter afforded him significant mitigation even if the FSA were to find that he had engaged in misconduct. Moreover he also explained how the bank's failure and the subsequent investigation by the FSA had severely impacted upon him.

5.38. Mr Cummings did not advance any specific submissions arguing against the imposition of an order which would prohibit him from performing any significant influence function in any authorised firm that is a Bank, Building Society, BIPRU investment firm, Insurer or part of a group containing such firms (as defined in the FSA Handbook).

**Findings**

5.39. The FSA considers that there is clear and compelling evidence that Mr Cummings' conduct in the Relevant Period constituted a breach of Statement of Principle 6 and also that he was knowingly concerned in a breach of Principle 3 by HBOS.

*The decision to bring action against Mr Cummings alone*

5.40. The FSA finds that there is clear and compelling evidence that Mr Cummings' conduct fell short of the requisite standards. The FSA rejects the submission that the case against him is founded upon a determination by the FSA to have a regulatory outcome against at least one individual in connection with the financial crisis.

5.41. Additionally the FSA concludes that there is no inherent unfairness in this action being brought against Mr Cummings alone. The FSA recognises that Mr Cummings did not submit that the action against him should be discontinued solely because he was the only individual facing disciplinary action in connection with the financial crisis. The FSA's view is that this case is to be determined on its own facts and merits.

*The test to be applied when assessing Mr Cummings' conduct*

5.42. The FSA considers that it is appropriate, when deciding whether or not Mr Cummings' conduct fell below the requisite standard, to determine if the systems and controls at Corporate were as seriously deficient as alleged. The FSA finds that there were such serious deficiencies.

5.43. The FSA accepts that it is necessary to consider if Mr Cummings was personally at fault for the problems that have been identified within Corporate and for the pursuit of a business strategy which required better controls being in place. The FSA accepts that action can not be taken against Mr Cummings on a strict liability basis. However the FSA considers that Mr Cummings was personally responsible for the matters set out in this notice. In reaching this finding the FSA has taken into account and applied the test outlined by the Upper Tribunal in the Pottage case.

5.44. The FSA also accepts that it would be unfair to bring action against Mr Cummings simply because he made decisions which have been shown to have been the wrong decisions to have taken in the light of the failure of HBOS. The FSA agrees that it should assess the reasonableness of the decisions made by Mr Cummings when determining if those decisions, in the areas for which he was responsible, make him culpable for breaches of the relevant regulatory standards. In assessing the reasonableness of Mr Cummings' conduct the FSA has decided that his actions were not those which a person in his position and acting with due skill care and diligence in managing the business of the Firm would have taken. Furthermore the FSA considers that Mr Cummings was knowingly concerned in the Firm's failure to take reasonable care to organise and control its affairs responsibly and effectively with adequate risk management systems.

5.45. The FSA notes Mr Cummings' representations about the standard of proof required in this case. The FSA makes this decision having regard to the fact that, pursuant to section 66 of the Act, the FSA has the power to impose a financial penalty where it appears to the FSA that a person is guilty of misconduct and the FSA is satisfied that it is appropriate in all the circumstances to take action against him. The FSA also has had regard to the fact that the Upper Tribunal, in regulatory cases, applies the civil standard of proof. The FSA considers that there is clear and compelling evidence that Mr Cummings breached Statement of Principle 6 and that he was knowingly concerned in HBOS's breach of Principle 3.

*The danger of considering aspects of Mr Cummings' conduct in isolation*

5.46. The FSA agrees that it would be unfair to focus upon a small portion of Mr Cummings' conduct in the Relevant Period. Instead, in reaching the decision in this matter, the FSA has adopted the 'holistic' approach which was advocated by Mr Cummings: the FSA has considered all of the relevant material.

*Mr Cummings' approach to risk management*

5.47. The FSA accepts and acknowledges that Mr Cummings made significant efforts to implement Basel II and to improve the controls and the risk management within Corporate. The FSA also accepts that during the Relevant Period the FSA's supervisors had not suggested that the state of the controls relating to the management of risk were such that the strategy being employed by the Corporate Division was evidently unreasonable. However the FSA finds that Mr Cummings is culpable for a regulatory breach because he was aware or should have been aware of the serious problems within the Corporate Division and yet he pursued a growth strategy which could not be supported by such deficient systems.

5.48. The FSA considers that Mr Cummings was aware or should have been aware that there were serious deficiencies in the control framework and that there were serious deficiencies with the framework for the management of credit risk across the portfolio. The serious deficiencies in the control framework meant that it failed to provide robust oversight and challenge to the business, whilst the serious deficiencies with the management of credit risk meant that there was a lack of focus on the need to manage risk across the portfolio as a whole. Furthermore the FSA considers that Mr Cummings was aware or should have been aware that there were serious deficiencies in the distribution framework. These problems meant that the distribution framework did not operate effectively to reduce the risk in the portfolio.

5.49. Furthermore the FSA finds that, as Mr Cummings was aware or should have been aware over the course of the Relevant Period, there were significant issues as to the quality, reliability and utility of the available management information. Mr Cummings ought to have been aware that these issues directly affected the effectiveness with which the risks of the business could be assessed, managed and mitigated.

5.50. The FSA considers that Mr Cummings' decision to direct the aggressive growth strategy when he was or should have been aware of the issues with the management, control and distribution frameworks was an unreasonable decision to have made.

*Corporate Division's strategy*

5.51. The FSA does not bring this action on the basis that Mr Cummings was engaged in reckless lending. The FSA does not specifically criticise the pursuit of an aggressive growth strategy on its own. Rather the FSA's action is founded upon the basis that Corporate, at Mr Cummings' direction, pursued a growth strategy which placed a significant reliance on the business having adequate systems and controls, at a time when he knew or should have been aware that these systems and controls were seriously deficient.

5.52. The FSA finds that notwithstanding Mr Cummings' representations it is clear that he directed Corporate to pursue an aggressive growth strategy at a time when there were serious weaknesses in the systems and controls in place. The FSA accepts that the growth targets were agreed with the Group Board and within the Corporate Division. Nonetheless the FSA considers that as the Chief Executive Officer of Corporate Mr Cummings was personally responsible for the setting and achievement of these targets. In making this finding the FSA notes that in his Senior Management Job Description it was explained that Mr Cummings was to:

> "*Provide strategic direction to the Corporate Division, direct financial performance to deliver agreed revenue, profitability and cost improvement targets in line with the stated aims of the Group.*"

5.53. The FSA considers that the serious deficiencies with the controls within Corporate meant that there was a high degree of risk associated with maintaining existing levels of business. Despite this, Mr Cummings directed the Corporate Division to pursue an aggressive growth strategy, in pursuit of which it entered into transactions of increasing size, complexity and downside risk. This had the effect of increasing the already high level of risk and exposure to the economic cycle in the portfolio at a time when it was recognised within the Corporate Division that there were indications that the economic cycle was at or near a peak. The FSA finds that the foregoing makes Mr Cummings culpable for a breach of Statement of Principle 6 and for being knowingly concerned in the Firm's breach of Principle 3.

*The economic outlook and the unforeseen severity and speed of the crisis*

5.54. The FSA accepts that the full severity of the financial crisis was not reasonably foreseeable during the early part of the Relevant Period. However the FSA does not consider that this excuses Mr Cummings' conduct. Whilst the FSA accepts that the regulatory investigation leading to action may not have arisen had the economic environment remained relatively benign and had HBOS not failed, nonetheless the FSA considers that Mr Cummings' conduct fell below the standards which the FSA expects of an individual in his position. The severity of the financial crisis caused many of the transactions, which the Corporate Division had entered into, to become stressed. However the FSA does not criticise Mr Cummings simply because it now questions the wisdom of entering into these transactions. Instead the FSA considers that Mr Cummings has committed a regulatory breach because in the Relevant Period Corporate, under his direction, entered into these high risk transactions as part of its growth strategy, at a time when it did not have the systems and controls in place to be able to manage such business. The FSA considers that his conduct would have amounted to a regulatory failing at any time in the economic cycle. The severity of the financial crisis merely served to highlight the potentially disastrous consequences of such conduct.

*The alleged failings in the systems and controls*

5.55. The FSA finds that there were serious deficiencies in the systems and controls within the Corporate Division. The FSA therefore rejects Mr Cummings' submission that though these controls could have been improved they were adequate throughout the Relevant Period. The FSA considers that the improvements Mr Cummings was seeking to make were necessary because of the serious failings across the control framework and with the management of credit risk.

5.56. The FSA also rejects the submission that Mr Cummings' conduct must have met the appropriate regulatory standards because during the Relevant Period the FSA did not object to the strategy pursued by Corporate. The FSA considers that Mr Cummings is responsible and culpable for his conduct in the Relevant Period. The FSA considers that significant influence function holders are responsible for the management of their firms: it is not for the FSA to duplicate their responsibilities or to approve all of their decisions and business judgements. Further the FSA considers that all authorised entities, whether large institutions or sole traders, are responsible for their own adherence to regulatory standards.

*The implementation of the growth strategy*

5.57. The FSA finds that the Corporate Division pursued an aggressive growth strategy under Mr Cummings' direction. In making this finding the FSA accepts that the growth targets, which Corporate was to meet, had been agreed with others within HBOS following the Group challenge process.

5.58. The FSA finds that Mr Cummings was aware or should have been aware of the seriousness of the problems with the control framework and the management of risk within the Corporate Division. The FSA therefore considers that he should have adopted a more prudent strategy until these problems were rectified because Corporate embarked upon a strategy which exposed HBOS to considerable risk without effective tools to manage this risk. Furthermore the FSA considers that the high risk profile of the portfolio meant that the business was highly vulnerable to an economic downturn. As market conditions began to worsen over the course of 2007, Mr Cummings did not seek to re-evaluate the risk appetite of the business or to restrict the risk profile of new transactions. Instead after August 2007 he directed the business to increase market share as other lenders started to pull out of the markets in which Corporate operated. Rather than identify that a more prudent approach was vital as market conditions began to worsen, the Corporate Division, under Mr Cummings' direction, continued to pursue a strategy of aggressive growth.

5.59. Furthermore the FSA finds that in addition to directing the pursuit of an aggressive growth strategy Mr Cummings was directly involved in the implementation of this strategy. The FSA finds that Mr Cummings was personally involved in the sanctioning of high value and high risk transactions. The FSA considers that this involvement gave Mr Cummings a clear insight into the nature of the transactions which were being conducted in pursuit of the aggressive growth strategy.

*Migration of stressed assets*

5.60. The FSA rejects Mr Cummings' representations that the Corporate Division had in place an adequate framework for the management and control of the migration of stressed assets. Instead the FSA finds that the controls in this area were seriously deficient. Moreover the FSA considers that Mr Cummings was aware or should have been aware that there were these serious deficiencies in the process for the management of transactions showing signs of stress, particularly in the light of his personal involvement in the oversight of high value and high risk stressed transactions. The FSA considers that the speed and severity of the financial crisis highlighted these failings but the FSA rejects the suggestion that were it not for the crisis the controls would have been adequate. The FSA considers that the deficiencies in the process for the identification and management of transactions which showed signs of stress meant that they were neither identified promptly nor managed effectively. The FSA considers that it was as a consequence of Mr Cummings' personal failings that these problems persisted and that the risks associated with an inadequate framework for the management of stressed transactions came to fruition.

5.61. The FSA finds that from April 2008 it was apparent to Mr Cummings that a number of high value transactions had begun to demonstrate signs of stress and that this was likely to worsen over the course of 2008. It was or should have been apparent to Mr Cummings that a prudent approach was essential in order to manage and mitigate the high degree of risk facing the business. However, the culture of optimism impeded the effective management of transactions as they became stressed. Transactions were consistently moved too late to the High Risk area of the Corporate Division. This delayed the assessment of transactions to determine whether they should be formally classified as stressed or impaired. There was a significant risk that this would have an impact on the Firm's capital requirements. It also meant that the full extent of stress in the Corporate portfolio was not sufficiently visible to the Firm's Group Board and Group control functions, auditors and regulators. This contributed to provisions being made at the optimistic rather than the prudent end of the range.

*Provisioning*

5.62. The FSA notes that Mr Cummings never provisioned outside of the range given by either the divisional risk function or HBOS's auditors. Nonetheless the FSA considers that Mr Cummings' approach to provisioning was unreasonable. Mr Cummings was informed by the divisional risk function and HBOS's auditors that the level of provisioning he was advocating was at the optimistic end of the scale. The FSA considers that Mr Cummings acted unreasonably in provisioning at this optimistic end of this scale because he was aware or should have been aware that those who had identified the acceptable range of provisioning could not have been aware of the full extent of the stress within Corporate's portfolio. The FSA therefore considers that as Mr Cummings was aware or should have been aware of the lack of sufficient visibility of the full extent of stress in the Corporate portfolio he should have adopted a more prudent approach to provisioning.

*Mr Cummings' responsibility*

5.63. Whilst the FSA considers that Mr Cummings' conduct can not be wholly excused because others may have been involved in making some of the relevant decisions, the FSA does accept that this provides some mitigation for his misconduct. The FSA also accepts that Mr Cummings did rely on information given to him by others within the Corporate Division. Nonetheless the FSA considers that this must be balanced with the fact that within the federal structure at HBOS a significant degree of reliance had been placed upon Mr Cummings' judgement and experience. Moreover in his role he was obliged to have oversight of the systems and controls of the firm and he was required to take reasonable steps to ensure that Corporate's systems and controls were compliant with the relevant regulatory standards. The FSA considers that Mr Cummings failed to discharge his regulatory obligations by directing Corporate to pursue an aggressive growth strategy at a time when he knew or should have known that the systems and controls were not adequate to sustain such a strategy. Furthermore the FSA also considers that Mr Cummings failed to take reasonable steps to ensure that the Corporate division properly managed the migration of stressed assets to High Risk.

5.64. Furthermore the FSA rejects the suggestion that it is wrong to bring disciplinary action against Mr Cummings, personally, when he had initiated a number of projects to rectify the problems within the Corporate Division. The FSA considers that the seriousness of the deficiencies within Corporate was visible to Mr Cummings and therefore he was aware or should have been aware of the risks associated with pursuing the aggressive growth strategy. The FSA therefore considers that it is appropriate to bring action against Mr Cummings. The FSA rejects the suggestion that this action will discourage others from embarking upon change programmes. Instead the FSA considers that this action will highlight to significant influence function holders the importance of acting prudently whilst they are attempting to rectify deficient systems and controls. Further the FSA considers that this action will emphasise to significant influence function holders that they must take responsibility for ensuring that appropriate regard is paid to the risks of the business, with a higher risk business strategy requiring a commensurately higher and more robust control framework.

*Sanctions*

5.65. The FSA considers that, in the light of Mr Cummings' misconduct, it is appropriate in this matter to impose a financial penalty under section 66 of the Act. The FSA considers that the seriousness of Mr Cummings' misconduct merits a significant financial penalty. The FSA reaches these conclusions having taken into account Mr Cummings' representations concerning the need to avoid any disparity between the financial penalty imposed on him and other penalties imposed in other cases. The FSA considers that as a consequence of the particular circumstances in this matter, there is no disparity between the penalty to be imposed upon Mr Cummings and the penalties imposed in other cases involving significant influence function holders who have engaged in misconduct not involving dishonesty or a lack of integrity. The FSA also does not consider that there is a disparity between the penalty to be imposed upon him and the sanction imposed upon Bank of Scotland in the Final Notice issued on 9 March 2012. The FSA considers that the reasons given for the lack of a financial penalty in that case justify the difference between the sanction imposed upon the bank and the penalty to be imposed upon Mr Cummings.

5.66. In setting the financial penalty in this matter the FSA has taken into account the mitigation available to Mr Cummings. The FSA considers the financial penalty to be set at the appropriate level notwithstanding the severe impact that this matter has had upon Mr Cummings.

**Conclusions**

5.67. In the light of the foregoing the FSA has concluded that Mr Cummings has breached Statement of Principle 6 and that he was knowingly concerned in the Firm's breach of Principle 3.

*Breach of Statement of Principle 6*

5.68. The FSA concludes that during the Relevant Period, Mr Cummings failed to exercise due skill, care and diligence in managing the business of the firm for which he was responsible in his controlled function in that:

(1) between January 2006 and March 2008, the Corporate Division under Mr Cummings' direction pursued an aggressive growth strategy, with a specific focus on high risk, sub-investment grade lending. This was done despite weaknesses in the control framework, which meant that it failed to provide robust oversight and challenge to the business. Further, the Corporate Division continued to pursue this aggressive strategy under Mr Cummings' direction as market conditions began to worsen in the course of 2007. Mr Cummings failed to ensure that reasonable steps were taken to assess, manage or mitigate the risks involved in the aggressive growth strategy; and

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

*Knowing concern in a breach of Principle 3*

5.69. The FSA concludes that between January 2006 and March 2008, HBOS failed to take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems, in that:

(1) HBOS did not have adequate risk management systems for the high risk business and lending strategy which it pursued;

(2) HBOS did not have adequate risk management systems for the aggressive growth strategy it pursued; and

(3) HBOS did not therefore take reasonable care to organise and control its affairs responsibly and effectively in its pursuit of the high risk business and lending strategy and the aggressive growth strategy.

5.70. Mr Cummings was knowingly concerned in these failures by the Firm albeit that he made significant efforts towards improving matters within the Corporate Division.

5.71. Further, between April and December 2008, HBOS failed to take reasonable care to organise and control its affairs responsibly and effectively with regard to the Corporate Division's management of high value transactions which showed signs of stress.

5.72. Mr Cummings was also knowingly concerned in these failures by the Firm.

5.73. These failings had, or might reasonably be regarded as being likely to have had, a negative effect on:

(1) confidence in the UK financial system; and/or

(2) the ability of the Firm to meet the "fit and proper" test in threshold condition 5 (Suitability).

## 6. ANALYSIS OF SANCTIONS

6.1. The FSA has taken all the circumstances of this case into account in deciding that the imposition of a financial penalty in this case is appropriate, and that the level of the penalty is proportionate.

6.2. The FSA's policy on the imposition of financial penalties and public censures is set out in the FSA's Decision Procedure & Penalties manual ("DEPP") and Enforcement Guide ("EG"). In determining the financial penalty, the FSA has had regard to this guidance as it applied at the time of the misconduct. Consequently the FSA has also had regard to the provisions of the Enforcement Manual ("ENF"), which were in force for the early part of the Relevant Period.

**Factors relevant to the appropriate financial penalty**

6.3. The FSA's general approach in deciding whether to take action and determining the appropriate level of financial penalties is set out in Chapter 6 of DEPP, of the FSA Handbook (and in Chapter 13 of ENF).

6.4. The principal purpose for which the FSA imposes financial penalties is to promote high standards of regulatory conduct by deterring those who have breached regulatory requirements from committing further breaches, helping to deter others from committing similar breaches and demonstrating generally the benefits of compliant behaviour.

6.5. These breaches of Statement of Principle 6 and/or Mr Cummings' knowing concern in these breaches of Principle 3 are sufficiently serious to merit the imposition of a substantial financial penalty.

6.6. The FSA considers that a substantial financial penalty is required to strengthen the message to the industry that senior managers holding significant influence functions must take responsibility for ensuring that appropriate regard is paid to the risks of the business, recognising that a higher risk business strategy will require a commensurately higher and more robust control framework.

6.7. In determining whether a financial penalty is appropriate and proportionate, the FSA considers all the relevant circumstances of the case. DEPP 6.5.2G sets out a non-exhaustive list of factors that may be of relevance in determining the amount of a financial penalty. In deciding the appropriate penalty, the FSA considers the factors outlined below to be particularly relevant:

*Deterrence: DEPP 6.5.2G(1)*

6.8. In determining the appropriate level of penalty, the FSA has had regard to the need to promote high standards of regulatory conduct by deterring those who have committed breaches from committing further breaches and to help to deter others from committing similar breaches.

*The nature, seriousness and impact of the breach: DEPP 6.5.2G(2)*

6.9. It is considered that Mr Cummings' failings are particularly serious in the light of the following:

(1) it was clear that the aggressive growth strategy that he pursued would necessarily entail a significant increase in the already high level of risk and exposure to the economic cycle in the portfolio, at a time when Mr Cummings recognised or should have recognised that there were indications that the economic cycle was at or near a peak;

(2) Mr Cummings was personally involved in the sanctioning of high value and high risk transactions;

(3) rather than identify that a more prudent approach was vital as market conditions began to worsen, Mr Cummings continued to pursue a strategy of aggressive growth;

(4) Mr Cummings was personally involved in the oversight of stressed transactions, which were high value and high risk;

(5) Mr Cummings provisioned at the optimistic end of the scale that was given by the divisional risk function and HBOS's auditors even though he was aware, or should have been aware, that the full extent of the stress within Corporate's profile was not visible to the risk function and auditors; and

(6) HBOS placed a significant degree of reliance on Mr Cummings' judgement and experience particularly in the light of the federal structure in place.

*The extent to which the breach was deliberate or reckless: DEPP 6.5.2G(3)*

6.10. It is not alleged that Mr Cummings deliberately breached the regulatory provisions nor that he was reckless.

*Whether the person on whom the penalty is to be imposed is an individual: DEPP 6.5.2G(4)*

6.11. The FSA has had regard to the fact that Mr Cummings is an individual.

*The size, financial resources and other circumstances of the person on whom the penalty is to be imposed: DEPP 6.5.2G(5)*

6.12. Mr Cummings has not contended that the financial penalty referred to in paragraph 1.1 will cause him serious financial hardship.

*The amount of benefit gained: DEPP 6.5.2G(6)*

6.13. The structure of Mr Cummings' remuneration meant that he benefited directly from an increase in the profitability of the business.

*Conduct following the breach: DEPP 6.5.2G(8)*

6.14. Mr Cummings has co-operated with the FSA's investigation.

*Disciplinary record and compliance history: DEPP 6.5.2G(9)*

6.15. Mr Cummings has not previously been the subject of any enforcement action. It is accepted that prior to the matters set out in this Decision Notice, Mr Cummings had an unblemished disciplinary and compliance record.

**Factors mitigating the financial penalty**

6.16. It is accepted that:

(1) a number of the deficiencies in the control framework and the issues with the approach to risk management pre-dated the appointment of Mr Cummings as Chief Executive of the Corporate Division;

(2) Mr Cummings made significant efforts to improve the control framework and the approach to risk management. In particular he initiated a number of projects which were designed to address these problems and he implemented a number of improvements during the Relevant Period;

(3) there was a severe financial crisis and economic downturn in the course of the Relevant Period, which had a significant impact on the Corporate Division, the full severity of which was not reasonably foreseeable during the early part of the Relevant Period;

(4) the assessment of credit quality and impairment requires the exercise of management judgement;

(5) whilst a significant degree of reliance was placed upon Mr Cummings' judgement and experience he did not take all of the decisions alone. The FSA acknowledges that critical business decisions were taken collectively; and

(6) Mr Cummings did not deliberately or recklessly breach regulatory provisions.

6.17. Notwithstanding these matters, the FSA considers that Mr Cummings' conduct was not sufficient to discharge his regulatory obligations. These matters do however serve as mitigation in relation to the level of penalty.

6.18. The FSA has also taken into account in determining the level of penalty the fact that Mr Cummings voluntarily waived his contractual entitlement to a deferred bonus of £1.3 million, when he left the Firm in January 2009. This bonus related to Mr Cummings' performance in 2007 and was due to be paid to him in 2010.

**Conclusion as to financial penalty**

6.19. Accordingly, the FSA considers it necessary and proportionate to impose a financial penalty of £500,000, pursuant to section 66 of the Act, on the grounds that Mr Cummings failed to exercise due skill, care and diligence in managing the business of the Firm for which he was responsible in his controlled function and that Mr Cummings was knowingly concerned in the failure of the Firm to take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems.

**Fitness and propriety**

6.20. The FSA has had regard to the guidance in Chapter 9 of EG in deciding that is appropriate in this case to make an order prohibiting Mr Cummings from performing any significant influence function in any authorised firm that is a Bank, Building Society, BIPRU investment firm, Insurer or part of a group containing such firms (as defined in the FSA Handbook) on the grounds that he lacks competence and capability to perform such functions.

6.21. The facts and matters set out above indicate that Mr Cummings lacks competence and capability to perform specific significant influence functions such that it is appropriate to make a prohibition order.

**Prohibition order**

6.22. Accordingly the FSA considers it appropriate to make a prohibition order prohibiting Mr Cummings from performing any significant influence function in any authorised firm that is a Bank, Building Society, BIPRU investment firm, Insurer or part of a group containing such firms (as defined in the FSA Handbook) on the grounds that he lacks competence and capability to perform such functions.

## 7. PROCEDURAL MATTERS

**Decision maker**

7.1. The Decision Makers were those under DEPP 5.1, Mr Cummings having decided not to refer the matter to the Upper Tribunal.

7.2. This Final Notice is given under, and in accordance with, section 390 of the Act.

**Manner of and time for payment**

7.3. The financial penalty must be paid in full by Mr Cummings to the FSA by no later than 12 October 2012, 30 days from the date of the Final Notice.

**If the financial penalty is not paid**

7.4. If all or any of the financial penalty is outstanding on 13 October 2012, the FSA may recover the outstanding amount as a debt owed by Mr Cummings and due to the FSA.

**Publicity**

7.5. 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 FSA must publish such information about the matter to which this notice relates as it 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.

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

**FSA contacts**

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

**…………………………………**

**William Amos**

**FSA Enforcement and Financial Crime Division**

## ANNEX TO FINAL NOTICE

## GUIDANCE AND POLICY TO STATUTORY PROVISIONS AND RULES

### 1. Controlled Functions

1.1. The FSA's regulatory objectives, as set out in section 2(2) of the Financial Services and Markets Act 2000 (FSMA or the Act), include the maintenance of market confidence and the protection of consumers.

1.2. Section 59 of the Act provides that approval is necessary in respect of a controlled function which is performed under an arrangement entered into by a firm in relation to its regulated activity.

1.3. SUP 10.3.1 R provides: '*A function is a controlled function only to the extent that it is performed under an arrangement entered into by: (1) a firm… in relation to the carrying on by the firm of a regulated activity.*'

1.4. SUP 10.4.5 R contains a table of controlled functions. The director function is CF1, the systems and controls function is CF28 and the significant management function is CF29.

1.5. CF1 is described more fully in SUP 10.6.4 R: *'… the director function is the function of acting in the capacity of either a: (1) director (other than non-executive director) of that firm; …'.*

1.6. SUP 10.6.2 R provides: '*Each of the governing functions… includes where apportioned under SYSC 2.1.1 R or SYSC 4.3.1 R and SYSC 4.4.3 R:*

*(1) the systems and controls function; and*

*(2) the significant management function.*'

1.7. CF28 is described more fully in SUP 10.8.1 R: '*The systems and controls function is the function acting in the capacity of an employee of the firm with responsibility for reporting to the governing body of a firm, or the audit committee (or its equivalent) in relation to:*

(1) *its financial affairs;*

(2) *setting and controlling its risk exposure; and*

(3) *adherence to internal systems and controls, procedures and policies.*'

1.8. CF29 is described more fully in SUP 10.9.10 R (1): '*The significant management function is the function of acting as senior manager with significant responsibility for a significant business unit that:*

(a) *carries on designated investment business or other activities not falling within (b) to (d);*

(b) *effects contracts of insurance (other than contractually based investments);*

(c) *makes material decisions on the commitment of a firm's financial resources, its financial commitments, its assets acquisitions, its liability management and its overall cash and capital planning;*

(d) *processes confirmations, payments, settlements, insurance claims, client money and similar matters.*'

## 2. Statements of Principle and Code of Practice for Approved Persons (APER)

### *General Guidance*

2.1. Under section 66(1) of the Act, the FSA may take action against a person if (a) it appears to the FSA that he is guilty of misconduct; and (b) if the FSA is satisfied that it is appropriate in all the circumstances.

2.2. Section 66(2) of the Act provides that a person is guilty of misconduct if, while an approved person, he has (a) failed to comply with a Statement of Principle issued under section 64 of the Act; or (b) been knowingly concerned in a contravention by the relevant authorised person of a requirement imposed on that authorised person under the Act.

2.3. The FSA's Statements of Principle and Code of Practice for Approved Persons (APER) have been issued by the FSA under section 64 of the Act. Statement of

Principle 6 states: '*An approved person performing a significant influence function must exercise due skill, care and diligence in managing the business of the firm for which he is responsible in his controlled function.'* (APER 2.1.2P)

2.4. The Code of Practice for Approved Persons (APER 3 and APER 4 in relation to general provisions and specific provisions respectively) sets out descriptions of conduct which, in the opinion of the FSA, do not comply with a Statement of Principle. It also sets out, in certain cases, factors which, in the opinion of the FSA, are to be taken into account in determining whether or not an approved person's conduct complies with a Statement of Principle.

2.5. APER 3.1.3 G provides: *'The significance of conduct identified in the Code of Practice for Approved Persons as tending to establish compliance with or a breach of a Statement of Principle will be assessed only after all the circumstances of a particular case have been considered. Account will be taken of the context in which a course of conduct was undertaken, including the precise circumstances of the individual case, the characteristics of the particular controlled function and the behaviour to be expected in that function.'*

2.6. APER 3.1.4 G (1) provides: '*An approved person will only be in breach of a Statement of Principle where he is personally culpable. Personal culpability arises where an approved person's conduct was deliberate, or where the approved person's standard of conduct was below that which would be reasonable in all the circumstances...*'.

2.7. APER 3.1.5 G provides: '*In particular, in determining whether or not an approved person's conduct complies with a Statement of Principle, the FSA will take into account the extent to which an approved person has acted in a way that is stated to be in breach of a Statement of Principle*.'

2.8. APER 3.1.6 G provides: '*The Code of Practice for Approved Persons (and in particular the specific examples of behaviour which may be in breach of a generic description of conduct in the code) is not exhaustive of the kind of conduct that may contravene the Statements of Principle.*'

2.9. A person performing a significant influence function is subject to the additional requirements set out in Statements of Principle 5 to 7 in performing that controlled function. APER 3.1.8 G provides: '*In applying Statements of Principle 5 to 7, the nature, scale and complexity of the business under management and the role and responsibility of the individual performing a significant influence function within the firm will be relevant in assessing whether an approved person's conduct was reasonable. For example, the smaller and less complex the business, the less detailed and extensive the systems of control need to be. The FSA will be of the opinion that an individual performing a significant influence function may have breached Statements of Principle 5 to 7 only if his conduct was below the standard which would be reasonable in all the circumstances…*'.

2.10. APER 3.2.1 E provides: '*In determining whether or not the particular conduct of an approved person within his controlled function complies with the Statements of Principle, the following are factors which, in the opinion of the FSA, are to be taken into account:*

*(1) whether that conduct relates to activities that are subject to other provisions of the Handbook;*

*(2) whether that conduct is consistent with the requirements and standards of the regulatory system relevant to his firm.'*

2.11. APER 3.3.1 E provides: *'In determining whether or not the conduct of an approved person performing a significant influence function complies with Statements of Principle 5 to 7, the following are factors which, in the opinion of the FSA, are to be taken into account:*

*(1) whether he exercised reasonable care when considering the information available to him;*

*(2) whether he reached a reasonable conclusion which he acted on;*

*(3) the nature, scale and complexity of the firm's business;*

*(4) his role and responsibility as an approved person performing a significant influence function; and*

(5) *the knowledge he had, or should have had, of regulatory concerns, if any, arising in the business under his control.'*

***Specific Guidance***

2.12. APER 4.5.14 G provides: '*If an individual's performance is unsatisfactory, then the appropriate approved person (if any) performing a significant influence function should review carefully whether to allow that individual to continue in position. In particular, if he is aware of concerns relating to the compliance with requirements and standards of the regulatory system (or internal controls) of the individual concerned, or of staff reporting to that individual, the approved person performing a significant influence function should take care not to give undue weight to the financial performance of the individual or group concerned when considering whether any action should be taken. An adequate investigation of the concerns should be undertaken (including, where appropriate, adherence to internal controls). The approved person performing a significant influence function should satisfy himself, on reasonable grounds, that the investigation is appropriate, the results are accurate and that the concerns do not pose an unacceptable risk to compliance with the requirements and standards of the regulatory system (see in particular Statement of Principle 6…*'.

2.13. In relation to Statement of Principle 6, APER 4.6 provides specific guidance and examples of behaviour that may contravene that Principle.

2.14. An example of conduct which, in the FSA's opinion does not comply with Principle 6 is where a significant influence function holder fails '*to take reasonable steps to adequately inform himself about the affairs of the business for which he is responsible*' (APER 4.6.3 E). APER 4.6.4 E provides that this type of behaviour '*includes, but is not limited to:*

(1) *permitting transactions without a sufficient understanding of the risks involved;*

(2) *permitting expansion of the business without reasonably assessing the potential risks of that expansion;*

(3) *inadequately monitoring highly profitable transactions or business practices or unusual transactions or business practices;*

(4) *accepting implausible or unsatisfactory explanations from subordinates without testing the veracity of those explanations; and*

(5) *failing to obtain independent, expert opinion where appropriate; (see APER 4.6.12 G).'*

2.15. APER 4.6.12 G includes the following guidance:

(1) *'It is important for the approved person performing a significant influence function to understand the business for which he is responsible (APER 4.6.4 E). An approved person performing a significant influence function is unlikely to be an expert in all aspects of a complex financial services business. However, he should understand and inform himself about the business sufficiently to understand the risks of its trading, credit or other business activities.*

(2) *It is important for an approved person performing a significant influence function to understand the risks of expanding the business into new areas and, before approving the expansion, he should investigate and satisfy himself, on reasonable grounds, about the risks, if any, to the business…'.*

2.16. APER 4.6.13 G deals with delegation:

(1) *'An approved person performing a significant influence function may delegate the investigation, resolution or management of an issue or authority for dealing with a part of the business to individuals who report to him or to others.*

(2) *The approved person performing a significant influence function should have reasonable grounds for believing that the delegate has the competence, knowledge, skill and time to deal with the issue. For instance, if the compliance department only has sufficient resources to deal with day-to-day issues, it would be unreasonable to delegate to it the resolution of a complex*

*or unusual issue without ensuring it had sufficient capacity to deal with the matter adequately.*

*(3) If an issue raises questions of law or interpretation, the approved person performing a significant influence function may need to take legal advice. If appropriate legal expertise is not available in-house, he may need to consider appointing an appropriate external adviser.*

*(4) The FSA recognises that the approved person performing a significant influence function will have to exercise his own judgment in deciding how issues are dealt with, and that in some cases that judgment will, with the benefit of hindsight, be shown to have been wrong. He will not be in breach of Statement of Principle 6 unless he fails to exercise due and reasonable consideration before he delegates the resolution of an issue or authority for dealing with a part of the business and fails to reach a reasonable conclusion…*'.

2.17. APER 4.6.14 G provides: '*Although an approved person performing a significant influence function may delegate the resolution of an issue, or authority for dealing with a part of the business, he cannot delegate responsibility for it. It is his responsibility to ensure that he receives reports on progress and questions those reports where appropriate. For instance, if progress appears to be slow or if the issue is not being resolved satisfactorily, then the approved person performing a significant influence function may need to challenge the explanations he receives and take action himself to resolve the problem. This may include increasing the resource applied to it, reassigning the resolution internally or obtaining external advice or assistance. Where an issue raises significant concerns, an approved person performing a significant influence function should act clearly and decisively. If appropriate, this may be by suspending members of staff or relieving them of all or part of their responsibilities…*'.

## 3. Principles for Businesses (PRIN)

3.1. The FSA's Principles for Businesses (PRIN) have been issued by the FSA under section 138 of the Act. Principle 3 (Management and control) states: '*A firm must* *take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems.'* (PRIN 2.1.1R)

3.2. PRIN 3.2.3 R provides: '*Principles 3, 4 and… 11… also:*

*(1) apply with respect to the carrying on of unregulated activities (for Principle 3 this is only in a prudential context); and*

*(2) take into account any activity of other members of a group of which the firm is a member.*'

3.3. '*Prudential context*' is defined in the FSA Handbook as: '*in relation to activities carried on by a firm, the context in which the activities have, or might reasonably be regarded as likely to have, a negative effect on:*

*(a) confidence in the UK financial system; or*

*(b) the ability of the firm to meet either:*

*(i) the "fit and proper" test in threshold condition 5 (Suitability); or*

*(ii) the applicable requirements and standards under the regulatory system relating to the firm's financial resources.*'

**4. Relevant provisions from the Senior Management Arrangements, Systems and Controls (SYSC) and the Threshold Conditions (COND)**

4.1. One of the purposes of SYSC, pursuant to SYSC 1.2.1 G, is '*to increase certainty by amplifying Principle 3, under which a firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems.*'

4.2. SYSC 4.2.1 R provides: '*The senior personnel of a common platform firm… must be of sufficiently good repute and sufficiently experienced as to ensure the sound and prudent management of the firm.*'

4.3. COND 2.5.1 (paragraph 5, schedule 6 to the Act) provides: '*The person concerned must satisfy the [FSA] that he is a fit and proper person having regard to all the circumstances, including:*

*(a) his connection with any person;*

*(b) the nature of any regulated activity that he carries on or seeks to carry on; and*

*(c) the need to ensure that his affairs are conducted soundly and prudently.*'

4.4. COND 2.5.4 G (2) provides: '*Relevant matters include, but are not limited to, whether a firm:*

*(a) conducts, or will conduct, its business with integrity and in compliance with proper standards;*

*(b) has, or will have, a competent and prudent management; and*

*(c) can demonstrate that it conducts, or will conduct, its affairs with the exercise of due, skill, care and diligence.*'

4.5. COND 2.5.7 G (6) provides: '*In determining whether a firm will satisfy and continue to satisfy threshold condition 5 in respect of having competent and prudent management and exercising due skill, care and diligence, relevant matters, as referred to in COND 2.5.4 G (2), may include… the firm has approached the control of financial and other risk in a prudent manner (for example, by not assuming risks without taking due account of the possible consequences) and has taken reasonable care to ensure that robust information and reporting systems have been developed, tested and properly installed…*'.

## 5. Prohibition Order Provisions

5.1. Under section 56 of the Act, the FSA may make a prohibition order if it appears to it that an individual is not a fit and proper person to perform functions in relation to a regulated activity carried on by an authorised person.

5.2. Section 56(2) of the Act provides that the FSA may make a prohibition order prohibiting an individual from performing a specified function, any function falling within a specified description or any function.

5.3. The Fit and Proper Test for Approved Persons (FIT) sets out and describes the criteria that the FSA considers when assessing the fitness and propriety of a candidate for a controlled function.

5.4. FIT 1.3.1 G provides that the FSA will have regard to a number of factors when assessing a person's fitness and propriety and identifies the three most important considerations to take into account. One of these three considerations is a person's competence and capability.

5.5. FIT 1.3.2 G provides: '*In assessing fitness and propriety, the FSA will also take account of the activities of the firm for which the controlled function is or is to be performed, the permission held by that firm and the markets within which it operates.*'

5.6. FIT 2.2.1 G provides: '*In determining a person's competence and capability, the FSA will have regard to all relevant matters including but not limited to:*

*(1) whether the person satisfies the relevant FSA training and competence requirements in relation to the controlled function the person performs or is intended to perform;*

*(2) whether the person has demonstrated by experience and training that the person is suitable, or will be suitable if approved, to perform the controlled function.*'

5.7. The FSA's policy in relation to the decision to make a prohibition order is set out in Chapter 9 of the Enforcement Guide (EG).

5.8. EG 9.1 sets out how the FSA's power to make a prohibition order under section 56 of the Act helps it work towards achieving its regulatory objectives. The FSA may exercise this power where it considers that, to achieve any of its objectives, it is appropriate either to prevent an individual from performing any functions in relation to regulated activities or to restrict the functions which he may perform.

5.9. EG 9.3 provides: '*In deciding whether to make a prohibition order and/or, in the case of an approved person, to withdraw its approval, the FSA will consider all the relevant circumstances including whether other enforcement action should be taken or has been taken already against that individual by the FSA. … in some cases the FSA may take other enforcement action against the individual in addition to seeking a prohibition order and/or withdrawing its approval.*'

5.10. EG 9.5 provides: '*The scope of a prohibition order will depend on the range of functions which the individual concerned performs in relation to regulated activities, the reasons why he is not fit and proper and the severity of risk which he poses to consumers or the market generally.*'

5.11. EG 9.8 to 9.14 set out guidance on the FSA's approach to making prohibition orders against approved persons.

5.12. EG 9.8 provides that, in deciding whether to make a prohibition order, the FSA will consider whether its regulatory objectives can be achieved adequately by imposing disciplinary sanctions.

5.13. Specifically in relation to approved persons, EG 9.9 provides that in deciding whether to make a prohibition order, the FSA will consider all the relevant circumstances of the case. These include, but are not limited to, the following:

(1) '*Whether the individual is fit and proper to perform functions in relation to regulated activities. The criteria for assessing the fitness and propriety of approved persons are set out in… FIT 2.2 (Competence and capability)...*' (EG 9.9(2))

(2) '*Whether, and to what extent, the approved person has:*

(a) *failed to comply with the Statements of Principle issued by the FSA with respect to the conduct of approved persons; or*

(b) *been knowingly concerned in a contravention by the relevant firm of a requirement imposed on the firm by or under the Act (including the Principles and other rules)…*' (EG 9.9(3))

(3) ‘*The relevance and materiality of any matters indicating unfitness.*’ (EG 9.9(5))

(4) ‘*The particular controlled function the approved person is (or was) performing, the nature and activities of the firm concerned and the markets in which he operates.*’ (EG 9.9(7))

(5) ‘*The severity of the risk which the individual poses to consumers and to confidence in the financial system.*’ (EG 9.9(8))

5.14. EG 9.11 provides: ‘*Due to the diverse nature of the activities and functions under which the FSA regulates, it is not possible to produce a definitive list of matters which the FSA might take into account when considering whether an individual is not a fit and proper person to perform a particular, or any, function in relation to a particular, or any, firm.*’ However, two examples of types of behaviour which have previously resulted in the FSA deciding to issue a prohibition order or withdraw the approval of an approved person, set out in EG 9.12, are a serious lack of competence and serious breaches of the Statements of Principle for approved persons.

## 6. The Decision Procedure and Penalties Manual (DEPP)

6.1. The FSA’s approach to deciding whether to impose a financial penalty, and the level of that penalty, is set out in Chapter 6 of DEPP. However, this chapter was amended on 6 March 2010 to implement the FSA’s new approach to penalty setting. Furthermore, it only came into force on 28 August 2007. Therefore, the provisions of DEPP set out below are those which were in force between 28 August 2007 and 16 January 2009, the end of the Relevant Period.

6.2. DEPP 6.2.4 G provided: ‘*The primary responsibility for ensuring compliance with a firm’s regulatory obligations rests with the firm itself. However, the FSA may take disciplinary action against an approved person where there is evidence of personal culpability on the part of that approved person. Personal culpability arises where the behaviour was deliberate or where the approved person’s standard of behaviour was below that which would be reasonable in all the circumstances at the time of the conduct concerned.*’

6.3. DEPP 6.2.7 G provided: '*The FSA will not discipline approved persons on the basis of vicarious liability (that is, holding them responsible for the acts of others), provided appropriate delegation and supervision has taken place (see APER 4.6.13 G and APER 4.6.14 G). In particular, disciplinary action will not be taken against an approved person performing a significant influence function simply because a regulatory failure has occurred in an area of business for which he is responsible. The FSA will consider that an approved person performing a significant influence function may have breached Statements of Principle 5 to 7 only if his conduct was below the standard which would be reasonable in all the circumstances at the time of the conduct concerned...*'.

6.4. DEPP 6.5.2 G stated: '*The following factors may be relevant to determining the appropriate level of financial penalty to be imposed on a person under the Act.*' Some of the relevant factors are set out below.

6.5. DEPP 6.5.2 G (2) related to '*the nature, seriousness and impact of the breach in question*' and provides: '*The FSA will consider the seriousness of the breach in relation to the nature of the rule, requirement or provision breached.*' Some of the considerations listed as being potentially relevant included:

(1) '*the duration and frequency of the breach*' (DEPP 6.5.2 G (2)(a));

(2) '*whether the breach revealed serious or systemic weaknesses in the person's procedures or of the management systems or internal controls relating to all or part of a person's business*' (DEPP 6.5.2 G (2)(b)); and

(3) '*the loss or risk of loss caused to consumers, investors or other market users.*' (DEPP 6.5.2 G (2)(d)).

6.6. DEPP 6.5.2 G (3) related to '*the extent to which the breach was deliberate or reckless.*' It further provided: '*The FSA will regard as more serious a breach which is deliberately or recklessly committed*'; and '*If the FSA decides that the breach was deliberate or reckless, it is more likely to impose a higher penalty on a person than would otherwise be the case.*' Some of the matters to which the FSA may have regard in determining whether a breach was deliberate or reckless include the following:

(1) ‘*whether the breach was intentional, in that the person intended or foresaw the potential or actual consequences of its actions*’ (DEPP 6.5.2 G (3)(a));

(2) ‘*where the person has not followed a firm’s internal procedures and/or FSA guidance, the reasons for not doing so*’ (DEPP 6.5.2 G (3)(b));

(3) ‘*where the person has taken decisions beyond its or his field of competence, the reasons for the decisions and for them being taken by that person*’ (DEPP 6.5.2 G (3)(c)); and

(4) ‘*whether the person has given no apparent consideration to the consequences of the behaviour that constitutes the breach.*’ (DEPP 6.5.2 G (3)(d))

6.7. DEPP 6.5.2 G (4) related to ‘*whether the person on whom the penalty is to be imposed is an individual*’ and provided: ‘*When determining the amount of a penalty to be imposed on an individual, the FSA will take into account that individuals will not always have the resources of a body corporate, that enforcement action may have a greater impact on an individual, and further, that it may be possible to achieve effective deterrence by imposing a smaller penalty on an individual than on a body corporate. The FSA will also consider whether the status, position and/or responsibilities of the individual are such as to make a breach committed by the individual more serious and whether the penalty should therefore be set at a higher level.*’

6.8. DEPP 6.5.2 G (5) related to ‘*the size, financial resources and other circumstances of the person on whom the penalty is to be imposed.*’ Some of the matters to which the FSA may have regard include the following:

(1) ‘*The FSA may take into account whether there is verifiable evidence of serious financial hardship or financial difficulties if the person were to pay the level of penalty appropriate for the particular breach. The FSA regards these factors as matters to be taken into account in determining the level of a penalty, but not to the extent that there is a direct correlation between those factors and the level of penalty.*’ (DEPP 6.5.2 G (5)(a))

(2) ‘*The purpose of a penalty is not to render a person insolvent or to threaten the person’s solvency. Where this would be a material consideration, the FSA will consider, having regard to all other factors, whether a lower penalty would be appropriate. This is most likely to be relevant to a person with lower financial resources; but if a person reduces its solvency with the purpose of reducing its ability to pay a financial penalty, for example by transferring assets to third parties, the FSA will take account of those assets when determining the amount of a penalty.*’ (DEPP 6.5.2 G (5)(b))

(3) ‘*The degree of seriousness of a breach may be linked to the size of the firm. For example, a systemic failure in a large firm could damage or threaten to damage a much larger number of consumers or investors than would be the case with a small firm: breaches in firms with a high volume of business over a protracted period may be more serious than breaches over similar periods in firms with a smaller volume of business.*’ (DEPP 6.5.2 G (5)(c))

(4) ‘*The size and resources of a person may also be relevant in relation to mitigation, in particular what steps the person took after the breach had been identified; the FSA will take into account what it is reasonable to expect from a person in relation to its size and resources, and factors such as what proportion of a person’s resources were used to resolve a problem.*’ (DEPP 6.5.2 G (5)(d))

6.9. DEPP 6.5.2 G (6) related to ‘*the amount of benefit gained or loss avoided*’ and provided: ‘*The FSA may have regard to the amount of benefit gained or loss avoided as a result of the breach, for example:*

*(a) the FSA will propose a penalty which is consistent with the principle that a person should not benefit from the breach;*

*(b) the penalty should also act as an incentive to the person (and others) to comply with regulatory standards and required standards of market conduct.’*

6.10. DEPP 6.5.2 G (8) related to ‘*conduct following the breach.*’ Some of the matters to which the FSA may have regard include the following:

(1) ‘*the conduct of the person in bringing (or failing to bring) quickly, effectively and completely the breach to the FSA’s attention…*’ (DEPP 6.5.2 G (8)(a); and

(2) ‘*the degree of co-operation the person showed during the investigation of the breach by the FSA… Where a person has fully co-operated with the FSA’s investigation, this will be a factor tending to reduce the level of financial penalty*’ (DEPP 6.5.2 G (8)(b)

6.11. DEPP 6.5.2 G (9) related to ‘*disciplinary record and compliance history.*’ It further provides: ‘*A person’s disciplinary record could lead to the FSA imposing a higher penalty, for example where the person has committed similar breaches in the past*’ and ‘*In assessing the relevance of a person’s disciplinary record and compliance history, the age of a particular matter will be taken into account, although a long-standing matter may still be relevant.*’ Some of the matters to which the FSA may have regard include the following:

(1) ‘*whether the FSA (or any previous regulator) has taken any previous disciplinary action against the person*‘ (DEPP 6.5.2 G (9)(a));

(2) ‘*whether the person has previously undertaken not to do a particular act or engage in particular behaviour*‘ (DEPP 6.5.2 G (9)(b)); and

(3) ‘*the general compliance history of the person, including whether the FSA (or any previous regulator) has previously brought to the person’s attention, including by way of a private warning, issues similar or related to the conduct that constitutes the breach in respect of which the penalty is imposed.*’ (DEPP 6.5.2 G 9(d)).

6.12. DEPP 6.5.2 G (10) related to ‘*other action taken by the FSA (or a previous regulator)*’ and provides: ‘*Action that the FSA (or a previous regulator) has taken in relation to similar breaches by other persons may be taken into account. This includes previous actions in which the FSA (whether acting by the RDC or the settlement decision makers) and a person on whom a penalty is to be imposed have reached agreement as to the amount of the penalty. … the FSA does not operate a tariff system. However, the FSA will seek to apply a consistent approach to determining the appropriate level of penalty.*’

## 7. Enforcement Manual (ENF)

7.1. Prior to the enactment of DEPP, the FSA's approach to financial penalties was set out in ENF. The provisions of ENF set out below were in force between 1 January 2006, the start of the Relevant Period, and 27 August 2007, the day prior to the enactment of DEPP.

7.2. ENF 13.3.3 G stated: '*The factors which may be relevant when the FSA determines the amount of a financial penalty for a firm or approved person include the following.*' Some of the relevant factors are set out below.

7.3. ENF 13.3.3 G (1)(a) related to '*the seriousness of the misconduct or contravention*' and provided: '*In relation to the statutory requirement to have regard to the seriousness of the misconduct or contravention, the FSA recognises the need for a financial penalty to be proportionate to the nature and seriousness of the misconduct or contravention in question. … in the case of an approved person, the FSA must have regard to the seriousness of the misconduct in relation to the nature of the Statement of Principle or requirement concerned...*'.

7.4. ENF 13.3.3 G (2) related to '*the extent to which the contravention or misconduct was deliberate or reckless*' and provided: '*In determining whether a contravention or misconduct was deliberate, the FSA may have regard to whether the… approved person's behaviour was intentional, in that they intended or foresaw the consequences of their actions. The matters to which the FSA may have regard in determining whether a contravention was reckless include, but are not limited to, the following:*

*(a) whether the… approved person has failed to comply with the firm's procedures;*

*(b) whether the… approved person has taken decisions beyond… his field of competence;*

*(c) whether the… approved person has given no apparent consideration to the consequences of the behaviour that constitutes the contravention.*

*If the FSA decides that behaviour was deliberate or reckless, it may be more likely to impose a higher penalty on… approved person than would otherwise be the case.*'

7.5. ENF 13.3.3 G (3) provided: '*Whether the person on whom the penalty is to be imposed is an individual, and the size, financial resources and other circumstances of the firm or individual. This will include having regard to whether the person is an individual, and to the size, financial resources and other circumstances of the… approved person. The FSA may take into account whether there is verifiable evidence of serious financial hardship or financial difficulties if the… approved person [was] to pay the level of penalty associated with the particular contravention or misconduct. The FSA regards these factors as matters to be taken into account in determining the level of a penalty, but not to the extent that there is a direct correlation between those factors and the level of penalty. The size and financial resources of [an] approved person may be a relevant consideration, because the purpose of a penalty is not to render [an] approved person insolvent or to threaten [his] solvency. Where this would be a material consideration, the FSA will consider, having regard to all other factors, whether a lower penalty would be appropriate; this is most likely to be relevant to… approved persons with lower financial resources; but if [an] individual reduces [his] solvency with the purpose of reducing [his] ability to pay a financial penalty, for example by transferring assets to third parties, the FSA will take account of those assets when determining the amount of a penalty. The size of the firm may also be a relevant consideration for the following reasons:*

*(a) the degree of seriousness of a contravention may be linked to the size of the firm. For example, a systemic failure in a large firm could damage or threaten to damage a much larger number of consumers than would be the case with a small firm: contraventions in firms with a high volume of business over a protracted period may therefore be more serious than contraventions over similar periods in firms with a smaller volume of business; and*

*(b) the size of a firm and its resources may also be relevant in relation to mitigation, in particular what steps the firm took after the contravention had been identified; the FSA will take into account what it is reasonable to expect from the firm in relation to its size and resources, and factors such as what proportion of a firm's resources were used to resolve a problem.*'

7.6. ENF 13.3.3 G (4) related to '*the amount of profits accrued or loss avoided'* and provided: '*The FSA may have regard to the amount of profits accrued or loss avoided as a result of the contravention or misconduct, for example:*

*(a) the FSA will propose a penalty which is consistent with the principle that [an] approved person should not benefit from the contravention or misconduct; and*

*(b) the penalty should also act as an incentive to the approved person (and others) to comply with regulatory standards.*'

7.7. ENF 13.3.3 G (5) related to '*conduct following the contravention*' and provided: '*The FSA may take into account the conduct of the… approved person in bringing (or failing to bring) quickly, effectively and completely the contravention or misconduct to the FSA's attention and:*

*(a) the degree of cooperation the… approved person showed during the investigation of the contravention or misconduct (where [an] approved person has fully cooperated with the FSA's investigation, this will be a factor tending to reduce the level of financial penalty);*

*(b) any remedial steps taken since the contravention or misconduct was identified, including identifying whether consumers suffered loss, compensating them, taking disciplinary action against staff involved (if appropriate), and taking steps to ensure that similar problems cannot arise in the future.*'

7.8. ENF 13.3.3 G (6) related to '*disciplinary record and compliance history*' and provided: '*The previous disciplinary record and general compliance history of the… approved person may be taken into account. This will include whether the FSA (or any previous regulator) has taken any previous formal disciplinary action, resulting in adverse findings, against the… approved person... For example, the disciplinary record of a … approved person could lead to the FSA increasing the penalty, where the… approved person has committed similar contraventions or misconduct in the past. In assessing the relevance of [an] approved person's disciplinary record and compliance history, the age of a particular matter will be taken into account, although a long-standing matter may still be relevant. However, in undertaking this assessment, private warnings will not be taken into account.*'

7.9. ENF 13.3.3 G (7) related to ‘*previous action taken by the FSA*’ and provided: ‘*The action that the FSA has taken previously in relation to similar behaviour by other … approved persons may be taken into account. The FSA will seek to ensure consistency when it determines the appropriate level of penalty. If it has taken disciplinary action previously in relation to a similar contravention or misconduct, this will clearly be a relevant factor. However, … the FSA does not intend to adopt a tariff system, and there may be other relevant factors which could increase or decrease the seriousness of the contravention or misconduct.*’