



INFORMATION FOR SHAREHOLDERS:

UPDATE ON HISTORIC FAILURES AT HBOS READING

BACKGROUND

In January 2017, six people, two of them former employees of HBOS, were convicted and sentenced to up to 12 years in prison for criminal misconduct between 2003 and 2007 through the HBOS Impaired Assets Division, London and South East Region, based in Reading ('HBOS Reading'). The convictions for conspiracy to corrupt, fraudulent trading and associated money laundering offences followed a police inquiry that began in mid-2010.

HBOS was acquired by Lloyds Banking Group in 2009. The Board and management team of Lloyds Banking Group have fully accepted the seriousness of the events centred on HBOS Reading which occurred prior to the acquisition and have been extensively engaged in leading the Group's response. The Group has publicly apologised for the harm done to victims and it has worked with the police, regulators and other authorities to get to the bottom of what happened and to ensure that the victims are treated fairly and compensated appropriately.

Following the outcome of the trial and after extensive consultation with the FCA, the Group has announced a number of steps designed to address customer and public concerns and to restore confidence.

1. **An independent customer compensation review and re-review:** In February 2017, the Group committed to reviewing the cases of all customers who might have been affected by criminal activities linked to HBOS Reading and to provide them swift and fair compensation. After consultation with the FCA, SME advocate Professor Russel Griggs OBE was appointed as the independent reviewer to conduct the HBOS Reading customer case review. Following the conclusion of the Customer Review in May 2019, the Group announced that an independent quality assurance review, led by Sir Ross Cranston would be undertaken to provide assurance that the Customer Review delivered fair and reasonable outcomes for customers. In December 2019, Sir Ross Cranston published his independent report and although he concluded that distress and inconvenience compensation was "generous, and beyond what a customer could hope to have been awarded under that head of loss by a court" he found that the Customer Review had failings a number of failings in its approach which meant that it did not achieve the purpose of delivering fair and reasonable outcomes for all customers. The Group fully supports his recommendation to offer customers the option of an independent re-review of their cases, looking again at the assessment of whether any direct and consequential losses flowed from the fraud. The Group Chief Executive is personally overseeing the Group's efforts to ensure those customers affected by the HBOS Reading fraud will get their claims properly addressed in an open and transparent manner.

In April this year, Sir Ross Cranston published an addendum to his report which outlined in more detail how the independent re-review of direct and consequential losses will be implemented for impacted customers. On his recommendation, retired High Court judge, Sir David Foskett, has been appointed to chair the independent re-review Panel. Sir Ross Cranston, working with victims of the HBOS Reading fraud, the All-Party Parliamentary Group on Fair Business Banking, SME Alliance and other stakeholders, has determined that the Panel should also comprise a dispute resolution expert and a forensic accountant to support the Chair. Sir David will be joined by Philippa Hill of Grant Thornton, a

forensic accountancy expert, and Andrew Hildebrand, a dispute resolution expert with SME experience.

Sir Ross also announced that Rory Phillips QC, who supported Sir Ross in the initial review, will lead the appeals body for the Group's *de facto* director and debt relief assessments, for which preparation is underway.

- 2. An independent review into how the Group handled the issue after acquiring HBOS in 2009:** While the criminal activity at HBOS Reading preceded the Lloyds Banking Group acquisition, the Group's Board has recognised legitimate questions over whether the issues relating to HBOS Reading were properly investigated and appropriately reported to the authorities following the acquisition. The Board therefore in April 2017 appointed Dame Linda Dobbs, a retired High Court judge, to undertake an independent review into these matters. The Group has committed to making the findings of Dame Linda's review available to regulators and to MPs in the House of Commons' Treasury Committee

The summary provided below is intended to help keep shareholders informed about these and other external investigations into the HBOS Reading events.

ONGOING INVESTIGATIONS INTO HBOS EVENTS PRIOR TO LLOYDS ACQUISITION

The FCA and its predecessor, the FSA, have undertaken a number of investigations into the management of HBOS prior to its acquisition by the Group in 2009. The FSA issued a Final Notice and censure in March 2012 that concluded HBOS Corporate Banking Division had failed to take reasonable care to organise and control its affairs responsibly and effectively. In this notice the FSA highlighted the serious breakdown of controls in HBOS Reading.

The element of the FSA investigation into events surrounding the discovery of misconduct at HBOS Reading between June 2006 and May 2009 was suspended during the course of the police investigation, at the request of the police. Following the convictions in early 2017 the FCA recommenced this investigation, with the FCA announcing its Final Notice on 21 June 2019. The Group provided its full cooperation to the FCA in producing their findings, which determined that while Bank of Scotland referred to the authority its suspicions that a fraud may have taken place at HBOS Reading, it had failed to be open and cooperative and failed to disclose information appropriately about those suspicions. The FCA judged these failures, which occurred during the period 3 May 2007 and 16 January 2009, were not intentional. As a result, the Group agreed to pay a fine of £45.5m.

The FCA has an ongoing investigation into certain former HBOS senior managers. The Group is not the subject of that investigation.

The investigation by Thames Valley Police (TVP) into fraud associated with HBOS Reading led to the successful conviction of six individuals in January 2017. On 30th April 2018, the National Crime Agency (NCA) announced that it would lead a pre-investigative review of evidence related to further allegations of fraud at HBOS Reading that fell outside the scope of the original police investigation. The purpose of this work is to determine whether there are sufficient grounds to launch further criminal investigations. The decision for the NCA to lead this review was reached after discussions between the FCA, SFO and other police forces. TVP's investigation is also ongoing. The Group continues to assist the NCA and TVP with their reviews to ensure any further potential crimes associated with these events are fully investigated.

LLOYDS ENGAGEMENT FOLLOWING ITS ACQUISITION OF HBOS

HBOS Reading has received senior level attention from Lloyds Banking Group since HBOS was acquired in 2009. After initial exchanges with the regulator in the first half of 2009, a formal review into the events at HBOS Reading was instructed in conjunction with the FSA in September 2009. This review reported in March 2010 and the information that came to light during this review helped the police to commence their criminal investigation later in 2010 which ultimately led to the January 2017 convictions.

Supporting the Police & Regulator Investigations

Whilst the police investigation was on-going, the Group's focus was to support their activity and avoid other actions that could prejudice any subsequent trial. This was consistent with the police request that the FSA suspend their investigations. A team with legal support was set up in the Group to provide the information required by the police, under the governance of a senior executive committee. During this period the Group was necessarily constrained in what it could do and say in relation to the on-going criminal investigation and a number of ongoing customer disputes were placed on hold while the police investigation was underway.

The Group supported the police investigation with the provision of a substantial volume of documents and witness statements. Separately, the police were able to use their extensive investigatory powers to pursue their inquiries in ways which were not open to the Group, including the ability to interview witnesses under caution and to gather information held outside of the Group.

Lloyds established an internal team to support both the regulatory and police enquiries throughout the period, but questions have remained about whether Lloyds could have done more to support the investigation.

Following the trial the Board established the independent review under Dame Linda Dobbs to assess whether the issues relating to HBOS Reading were properly investigated and appropriately reported to the relevant authorities after its acquisition of HBOS in 2009 until the end of the criminal trial in January 2017. This includes consideration of the Group's support for TVP and its handling of a document known as the 'Project Lord Turnbull Report'. This document was prepared by a former employee and notes in its introduction that it comprises detail from an interview that the employee had with TVP in July 2013. When received by the Group it was passed through our governance arrangements to the Regulator and the Police for their use in their ongoing enquiries into events at HBOS prior to Lloyds' acquisition. A joint statement with the author issued in November 2018 noted that the author acted in good faith and integrity in assisting the police investigation and in raising her concerns with the Group and confirmed that these concerns were documented following a request from the Group that she set out her concerns in writing. Both the Group and our former employee have agreed that Dame Linda Dobbs' review is the appropriate forum for considering matters in relation to the report.

Compensating customers impacted by the HBOS Fraud

Once the trial concluded and the risk of prejudice had passed, the Group sought to move quickly to set up a voluntary review to provide offers of compensation to customers whose businesses had been impacted by the fraudulent activities at HBOS Reading. Our aim was to avoid the delay and cost involved from customers having to pursue claims through the courts. The independent review under Professor Griggs OBE was established to provide compensation for any financial or consequential loss suffered and for the distress and inconvenience they had been caused by the events themselves. All these elements were taken into account in Professor Griggs' determination of the compensation level, with the Board setting the objective of providing fair compensation which would exceed that available to victims through a lengthy and costly legal process.

Following the conclusion of the Customer Review in May 2019, we recognised the need for public confidence in the review and we announced our commitment to provide assurance that customer outcomes were both fair and reasonable and to identify any lessons to be learned. We therefore agreed with the FCA that an independent Assurance Review would be undertaken by Sir Ross Cranston. When announcing the assurance review we committed to act upon any recommendations that Sir Ross made in his report.

In December 2019, Sir Ross Cranston published his independent report and found that the Customer Review had a number of failings in its approach which meant that it did not achieve the purpose of delivering fair and reasonable outcomes for all customers.

The Group has committed to implementing all his recommendations, including to offer all customers the option of an independent re-review of their cases, looking again at the assessment of any direct and consequential losses that flowed from the fraud. We want to emphasise our commitment to providing those customers who wish to opt in with an independent and transparent re-assessment, and we will be guided by victims and by stakeholders to ensure this process gives them confidence that they have received fair compensation and in a consistent way.

In late December 2019, following the publication of Sir Ross's report, the Group made a £35,000 ex gratia payment to all customers who were within the customer review to reflect that a re-review will take time and create further delays and distress for these customers.

As per Sir Ross's recommendations, we continue to reconsider all cases where an individual previously sought inclusion in the Customer Review, as well new cases brought forward, on the basis that they acted as a *de facto* director or that they were actively involved in running the business. We are making good progress with these assessments.

Furthermore, in January 2020 the Group communicated with 168 customers following Sir Ross's recommendation that we reconsider eligibility for debt relief payments. We continue to share preliminary assessments with affected customers and our goal is for all debt relief and *de facto* director assessments to be communicated as soon as we can. However, this will be subject to the impact of the Covid-19 pandemic.

Since the publication of Sir Ross's report, the Group has been working with victims, their supporters including the APPG on Fair Business Banking and the SME Alliance, and other stakeholders on how best to implement Sir Ross's recommendation for a re-review, including how it is undertaken and which independent expert (or experts) should be appointed to lead that review. Good progress is being made and, in particular, the Group welcomes Sir Ross's support in helping to set up the review, including his addendum to his original report and the appointment of Sir David Foskett to Chair the re-review Panel. The Group will continue to provide its full support to ensure this re-review begins as quickly as possible.

REFLECTIONS ON THE GROUP'S HANDLING OF HBOS READING

It is vital that Dame Linda Dobbs' review can conclude without the Group prejudicing the review's consideration on whether the issues relating to HBOS Impaired Assets office in Reading were investigated and appropriately reported to authorities at the time by Lloyds Banking Group. Nevertheless, while we await the full findings from Dame Linda's review, we believe there are a number of key lessons which we are already seeking to reflect in our business approach.

Lloyds' treatment of customers and handling of their complaints

As a result of the meetings the Group Chief Executive has had with HBOS Reading victims and by reviewing the way the Group handled customer complaints from the customers prior to the trial, the Group has identified the need to improve the way it engages and communicates with customers in similar situations. This includes the tone and format of engagement, to ensure greater empathy is shown to customers, even when we remain in disagreement, so that customers feel that they have been effectively listened to by the Group. Customers who came forward with complaints about their treatment in the HBOS Reading unit following the Group's acquisition of HBOS in 2009 viewed the Group as taking an overly defensive and legalistic approach, which lacked understanding and empathy for the victims of the fraud and this created unnecessary confrontation. It also undermined the customers' trust that the Group was willing to address the consequences from the HBOS fraud following the trial's conclusion in 2017. A less formal and legalistic approach might have fostered greater trust and, even when we could not reach agreement, greater acknowledgement of the legitimacy of the customer's views and beliefs might have ensured the customers felt their concerns were being properly listened to by the Group. The Group's concern that it not do anything that might prejudice an ongoing criminal investigation or the subsequent trial should not have prevented it from being more supportive to those who believed they were victims.

Lloyds' communications regarding evidence of fraud

As outlined earlier, the Group judged that it did not have sufficient evidence to establish fraud prior to the police investigation and needed to avoid prejudicing that investigation and subsequent trial through its public statements. However, some of the Group's communications could have been misinterpreted by stakeholders as a result of the Group not acknowledging in its statements that there were clear grounds for suspicion.

The Group could have been less defensive and explained more fully that it had provided material to the police as evidence for their investigation but would await the outcome of the trial to conclude whether individuals were guilty of committing fraud. A more open approach may have avoided or lessened stakeholders' perception that the Group was 'in denial'.

Lloyds' support for the police and regulatory investigation

In order to provide the police with information they had requested, which often contained personal client information, the Group's legal team followed normal protocol in asking the police to provide the Group with Court Production Orders prior to releasing this material. The failure to more effectively explain both our obligations and concerns regarding customer confidentiality and engaging proactively with the police to agree precise terms for the Production Orders with the investigating officers sometimes led to friction, with the police expressing concerns on occasions over the Group's cooperation.

Since the HBOS Reading investigation, the Group has sought to ensure that it is as fully supportive as possible in any subsequent police enquiries, proactively explaining its obligations and concerns and engaging with the police on Production Orders to ensure this does not unnecessarily delay the provision of material requested.

Due to the seriousness of the concerns relating to the support given to the police in the HBOS Reading investigation, the Dame Linda Dobbs review will assess whether the Group's support was handled appropriately at the time.

Lloyds' internal handling of HBOS Reading related material

During the police investigation the Group took and acted on extensive legal advice, including advice that it would be inappropriate to pursue its own investigation in order not to interfere with potential witnesses and prejudice the criminal trial. However, sticking closely to this legal approach meant that knowledge of confidential information collected for the police was not widely shared beyond the internal team overseeing this material and its legal advisers. These factors, while understandable, had the consequence that the nature of the fraud and the possible implications for customers was not given the level of interrogation and consideration by the wider management team that might have resulted from an internal Lloyds investigation, and created a number of challenges in ensuring appropriate cross Group co-ordination.

The establishment of the Customer Review

The Group's intention following the trial was to create a process that would provide rapid and generous compensation for the customers of HBOS Reading impacted by the fraud, without the delays and costs involved in a more legalistic process. The subsequent review of this process by Sir Ross Cranston, while noting that the awards for distress and inconvenience were generous, identified a number of failings in the way the review was conducted. In particular, in the desire for speed, insufficient consultation took place with interested parties to ensure they had confidence in the process; and the way direct and consequential loss was assessed was insufficiently open and transparent to provide confidence to customers in the review that any such losses were fairly assessed.

NEXT STEPS

The Board and Executive of Lloyds Banking Group recognise that the criminal activities that took place in HBOS Reading over a decade ago have not only had a damaging impact on the lives of those customers affected but have also cast a long shadow in undermining confidence and trust more widely. We are determined to learn from the failings made and take appropriate actions to change organisational behaviours in order to rebuild that trust.

In addition to meeting personally with many of the victims of the fraud, the Group Chief Executive has committed to a range of actions to embed a more empathetic approach to dealing with concerns from small business customers. This includes working with interested parties to establish a new Business Banking Resolution Service for small business customers to resolve disputes with banks. We are proud of the role we play in supporting the business community across the UK and are determined to ensure all aspects of our dealings with customers meet the high standards expected from the UK's leading domestic bank.

As the NCA, TVP and Dame Linda Dobbs reviews are all on-going it would not be appropriate for the Group to comment on their work or prejudge their findings, but we have no doubt there will be further lessons to be learned. We continue to assist all of these investigations. In relation to the re-review of customer cases following the Sir Ross Cranston review, the Group will provide its full support to Sir Ross and other stakeholders to ensure this his findings are implemented as quickly as possible.