There were a number of pivotal developments in Corporate division from 2006 relative to the above:

- Leveraged Finance
- Joint Ventures
- Other growth
- New internal risk ratings system
- Basel II Advanced Status
- "Discovery" of Reading Incident
- Financial crisis

Drilling KPMG's evidence down:

1) In assessing overall credit quality and impairment, KPMG would test HBoS' credit risk rating system, Days Past Due reporting, IAS provisioning modelling and collective provision model, impairment assessment and categorisation, and Specific Impairment Provisions.

   In relation to credit quality of the Good Book, which had not been subject to substantive testing then the new internal risk ratings system was fundamental.

   Where a new system is introduced that is to be relied on for audit purposes then that system must be subject to robust audit. The new risk rating system, including PD, EL and LGD, which were generated using historic experience of distressed credit, was a critical part of the Corporate models under the Basel II Advanced Internal Ratings Based Approach for credit risk. KPMG would know that the system was flawed.

2) The scope of an external audit of the financial statements technically did not cover the RWAs but the scope did cover consideration of the Going Concern concept. As such in considering the Going Concern concept in terms of the 2007 Audit Opinion and thereafter, a fundamental part of that assessment would be capital adequacy ratios, availability of wholesale funding and customer deposits, credit risk and impairment, distress, credit quality, liquidity, regulation, capital and funding requirements and sufficiency; all taken in light of the global financial crisis, which was escalating.

Accordingly it would be impossible to do this without auditing the Corporate Advanced IRB Approach models including calculations of RWAs, Tier 1 and Tier 2 capital calculations and capital adequacy ratios.

KPMG REPORTING OBLIGATIONS

Note: Reporting obligations to the FSA are discussed in Section Five.

Impact of the UK Anti-Money Laundering Legislation on Auditors' Responsibilities When Auditing and Reporting on Financial Statements

KPMG breached regulations and law in relation to the reporting of suspected money laundering relating to the Reading Incident.

POCA 2000 and the Money Laundering Regulations 2003 and 2007 do not extend the scope of the audit but auditors are within the regulated sector, and are required to report where:

- They know or suspect, or have reasonable grounds to know or suspect, that another person has engaged in money laundering; and
- The information has come to the Auditor's attention in the course of its regulated business.

Those in the regulated sector for money laundering purposes have a statutory duty to report actual or suspected money laundering to the Serious Organised Crime Agency, either directly or through their company's normal procedures.

Failure to report is a criminal offence. POCA overrides any requirement of confidentiality.

POCA does not contain de minimis concessions that affect the reporting requirements.

HBoS did not raise SARs in relation to the Reading Incident and KPMG had a responsibility to report but did not.

The external Auditor's obligations to report extend wider than SOCA. The Auditor must report actual or suspected fraud to management or the Board as well as the regulatory authority, even in circumstances where the company has already informed the regulatory authority.

There is criminality pertinent to the Reading Incident, which is outside the parameters of Operation Hornet and has not been investigated or reported. KPMG were the original Project Managers in relation to the Herbert Smith data room. Although they were seriously conflicted in this regard, KPMG, as Auditors and following their extensive investigation of Reading Incident cases in 2007, would know that the scope of Deloitte's s166 investigation was inappropriately restricted. This is a serious failing, in relation to a number of regulatory, statutory and professional obligations and duties.

SECTION NINE:
INSOLVENCY PRACTITIONERS AND INVESTIGATING ACCOUNTANTS

SECTION NINE

INSOLVENCY PRACTITIONERS AND INVESTIGATING ACCOUNTANTS

Firms have breached reporting obligations and have been involved in serious misconduct.

The firms involved include:

- PwC
- KPMG
- Hurst Morrison Thomson (now part of Tenon)
- Menzies Corporate Recovery / MCR Corporate Restructuring (now part of Duff & Phelps)

SUMMARY

Insolvency Practitioners, investigating accountants and accountants providing other accountancy services, appointed from January 2007, either knew, ought reasonably to have known or should have strongly suspected fraud and/or money laundering offences.

Insolvency Practitioners have additional obligations, which are discussed at the end of this section:

- Despite compelling and factual evidence or suspicious evidence of a very serious nature, not one of the Insolvency Practitioners appointed during 2007 and 2008 duly reported to SOCA their suspicions or evidence of director fraud or appointed Liquidators to investigate misfeasance by, or delinquency of, directors.

- It would appear in relation to such persons (David Mills and his associates either as directors or shadow directors) that no adverse reports on the conduct of Directors were submitted to the Insolvency Service.

- There may be repercussions for LBG in that a number of the relevant Insolvency appointments extended into LBG.

The Institute of Chartered Accountants in England and Wales: Duty to Report

Members of the ICAEW have a duty to report to the Institute where public interest requires the reporting of acts of misconduct which, if they were to go unreported could adversely affect the good name of the profession. In this regard the Institute considers it is in the public interest to discipline members whose conduct has fallen short of the high ethical and technical standards expected of members.

The Duty to Report is contained in bye-laws 9.1 and 9.2, and arises when a member is aware of facts or matters, which indicate that a duty to report has arisen. These include circumstances where a member (Chartered Accountant):

- Has committed any offence involving dishonesty, cheating or fraud;
- Has committed any imprisonable offence under Part V of the Criminal Justice Act 1993, FSMA and POCA;
- As a member [partner] of, or employee of a firm been in serious breach of the ICAEW's Audit Regulations;
- As an Insolvency Practitioner committed serious breach of the Insolvency Act or Rules or the ICAEW's Insolvency Licensing Regulations;
- Has been responsible for a serious breach of the Money Laundering Regulations 2003;
- Has committed a serious financial irregularity;
- Has committed a serious breach of faith in a professional respect.

It is important to note that the Duty to Report makes it clear that it is not enough merely to have suspicion.

Circumstances of crime, fraud and other serious misconduct are not protected by the duty of confidentiality.

Any substantial delay in reporting could amount to a failure to report, which of itself constitutes grounds for disciplinary action.

THE FIRMS

HMT and MCR

There is evidence of potential misconduct extending into their relationships with Quayside, David Mills, Lynden Scourfield and Mark Dobson.

KPMG

There is evidence of potential misconduct relating to Insolvency appointments in and subsequent to 2006. KPMG had a vested interest in their role as external Auditors not coming under scrutiny and challenge.

PwC

PwC accepted a number of sizeable IBR engagements and Insolvency appointments following the Peer Review, which commenced in January 2007. These included Bradman-Lake, Seoul Nassau and Corporate Jet Services. Not only did PwC not report their actual knowledge or suspicions of serious money laundering but additionally in the case of Corporate Jet Services, they sold assets to former directors when they had cause to suspect the legitimacy of the source of funds used for acquisition.

In relation to the companies to which they were appointed as Receivers or Administrators, no liquidators were appointed to investigate the conduct of directors / shadow directors or take action, and it would appear that no adverse reports into the conduct of David Mills and associates were submitted.

Additionally PwC may have been conflicted in other respects.

A timeline to demonstrate the above in relation to PwC and tying into what was occurring within the High Risk / Impaired Assets and Corporate arenas is set out below. The case being used is Corporate Jet Services. By the time PwC were appointed as Administrative Receivers to Corporate Jet Services in September 2007, their knowledge of the potential money laundering within Corporate Jet Services is likely to have been considerable, as would their actual and suspected knowledge of money laundering within Bradman-Lake, Seoul Nassau and with respect to the Reading Incident overall.

To keep it as simple as possible, the timeline uses only a few suspicious money laundering transactions as examples.

CJS had unauthorised lending in excess of £100m. Outwith Lynden Scourfield, at least five of Scourfield's Reading Team had been or were involved in CJS, and knew that CJS was not being reported properly via Management Information.

For the avoidance of any doubt, the Peer Review team at the very latest were aware of serious potential money laundering regarding CJS, Bradman-Lake, Seoul Nassau, Remnant Media, Clode, David Mills, and a number of other Reading Incident cases on 26 March 2007.

Date	
January 2002	PwC (Rob Birchall) are appointed as Receivers of Chauffair Ltd by HBoS
Summer 2002	To avoid a substantial loss for HBoS (£15m) a deal is negotiated with existing customer Aviation Worldwide Partners plc. Wayne Seymour is a board director and Anthony Shakesby is FD of AWP. Seymour and Shakesby are to be directors of the acquiring vehicle, CJS.
October 2002	Fraud of £13m is alleged against AWP and Seymour. AWP goes into Liquidation.
January 2003	The deal with CJS is negotiated as a standalone. Seymour is not a Board director but is to be CEO. Shakesby remains a director of CJS. David Mills is appointed a director, who has a close relationship with new Chairman, Robin Southwell.
Spring 2006	David Hurst is seconded from PwC and becomes Scourfield's "right hand man". Hurst is an Insolvency Practitioner from PwC's Corporate Recovery team. Hurst in heavily involved in CJS from June 2006, at which time CJS becomes public within HBoS via data cleansing as part of Basel II preparations. [Paul Burnett receives a Deckard Error report on 29 June 2006.] There is then a clear agenda to try to "hide" the largest Reading Incident cases with the most potential exposure to money laundering.
3 July 2006	Paul Burnett approves the Pre-Pack in relation to Speyside Angling Services Ltd (Mills company). The debt is clearly incapable of being serviced. Speyside is removed from all MI. In August, Burnett approves increased facilities for Speyside. The Credit Application shows the strategy, which is to "park" historic unserviceable debt of Speyside and Seoul Nassau, and transfer shares to a topco. Parked debt appears to be standalone, it is likely to be in excess of £35m.
Jul – Dec 06	CJS enters a period of intensive asset realisation e.g. Euromanx House is sold via a sale and lease back. HBoS provide a rental guarantee of £460k, a number of planes are sold with proceeds received in US$. A US$ manager's obligation account is set up and 2 other blocked deposit accounts.
July 2006	Sandy MacPherson, MD of Parkmead group is appointed a director of CJS. Parkmead acquired Quayside. Parkmead's bankers are Lloyds TSB. Mills was a director of Parkmead. PwC are appointed as Parkmead's Auditors in July 2006. By this time Southwell has sold his shares in CJS to The Sandstone Organisation, one of Mills' companies, and via which the Lloyds TSB loans are provided (guaranteed by HBoS, ultimate exposure £22m). The group includes a number of Isle of Man registered companies, including EuroManx Ltd in respect of which HBoS has also provided a guarantee of £2.5m to Isle of Man Bank relating to banking facilities they provide to Euromanx. HBoS has provided a significant number of other guarantees on behalf of the group. David Hurst (a PwC secondee) has knowledge of the guarantees and complex structures – he becomes the direct point of contact for CJS, and is involved in asset realisations, guarantees and application of funds.
22 August 2006	Tom Angus holds his first Lead Directors Meeting for Mid Value. First point on the agenda is the Corporate Credit Risk Committee Report.
August 2006	Paul Burnett carries out a portfolio review of Scourfield's own connections.

21 Sept 2006	Paul Burnett attends B-L presentation by Simon Wheatley (CEO & Quayside). A major restructuring is agreed in principle, which is intended to return the connection to the Good Book. [B-L via prior restructuring is owned by Mills' The Sandstone Organisation.] HBoS has guaranteed loans from Lloyds TSB (via Sandstone) and from Svenska Handelsbanken (July 2004) [known by David Hurst]. It would appear that Paul Burnett approved an increased overdraft facility of £30m, which he did not have the delegated authority to sanction.
End Sept 2006	FSA review of Nexus by which time data cleansing to be complete. Tom Angus is in receipt of error reports to monitor progress. CJS was an error on 1 Sept 2006.
October 2006	Tom Angus is concerned about Scourfield's team's portfolio and requests historic credit applications for a number of Scourfield's own connections. After a period of delay of a number of weeks, Scourfield submits them on 1 November 2006.
31 Oct 2006	Executive Committee Minutes of 31 October appear to indicate that Peter Hickman may have made reference to the Reading Incident.
30 Nov 2006	Evidence shows that Walker Morris is aware of the Clode Loans. Dornier Prop aircraft sold for $4.15m of which $2.2m repays CIT (HBoS guarantee released). Net proceeds were to be paid into blocked deposit account but are diverted to repay a Clode Loan. However lawyers later confirm that funds paid to Clode amount to $1.7m. No explanation is provided for balance of $250k.
Dec 2006	A new Lloyds TSB / Sandstone / Euromanx loan for £6.6m is provided. HBoS provide a guarantee to Lloyds TSB. The loan is for the committed purchase by Euromanx Gmbh of 2 aircraft, which have been on lease since May 2005.
3 Jan 2007	The Lloyds TSB loan had been converted into USD for the purposes of the transaction. $1.3m of "surplus" loan funds are placed in a Manager's Obligation Account.
12 Jan 2007	Tom again expresses concerns about London & South connections and sends Scourfield detailed trend information in advance of a meeting on 15 January. Despite having received copies of the historic credit applications from Scourfield on 1 November 2006, Tom Angus asks Paul Burnett whether he has seen and / or approved the Credit Applications. Paul Burnett denies knowledge of them in his response to Tom in February 2007.
22 Jan 2007	Peer Review of Reading commences. The Peer Review team are aware of the HBoS / Lloyds TSB bank guarantees.
2 Feb 2007	PwC (Rob Birchall) is engaged to carry out Independent Business Review and consideration of the Bank's options for Seoul Nassau followed later by Bradman-Lake.
February 2007	FSA is given assurance that in relation to Days Past Due Reporting, by 31 March 2007 the Corporate Good Book portfolio will not contain any connections where the limit has expired or covenants have been breached in excess of 90 days. DPD Reporting was to be a principal credit tool and was integral to Advance Bank Status.
9 March 2007	Scourfield goes on Sick Leave and is later suspended on 22 March 2007.

March 2007	Nick Davies, a director of Clode provides the Clode "corporate loan" spreadsheet to Tom Angus' team. All loans are connected to David Mills and "Reading" connections. The loans total £11m, and include loans to Sandstone, Justus (David Mills' personal Isle of Man company), indirectly Seoul Nassau and B-L. The team is fully aware that this is strong evidence of potential money laundering or financial crime. A GCM and GIA special project team run under David Miller (Head of Credit Sanction) and Group Credit Risk (Steven Clark) commence their review of the Reading Incident. (David Miller issues first report on the Reading Incident in May 2007.) Quayside fees totalling £250k are settled. All invoices except one minor one for a company in Administration are paid in full. PwC (David Chubb) are engaged to carry out Independent Business Review and consideration of the Bank's options for CJS. Reading Incident is reported to the FSA as an **internal credit control weakness**, which allowed "**a member of staff** extended unauthorised credit to impaired clients within commercial [mid value corporate] lending". No potential money laundering offences and/or fraud is reported. Corporate Financial Crime Prevention are not instructed to carry out a proper investigation. The scope of their investigation is severely restricted and relates only to Lynden Scourfield personally and to KYC checks.
12 April 2007	David Chubb is made aware of certain Clode loans. He confirms that Justus Ltd (Mill's personal Isle of Man company) owns the luxury yacht Powdermonkey and that a CJS company, Bluesky has lent Justus €104k. Bluesky was originally owned by Mills and Southwell, who transferred their shares to CJS. Chubb is aware that Bluesky owns another luxury yacht and he confirms that Clode originally gave a loan to Bluesky, which is now in the name of Clive Dixon. Bluesky also have a marine mortgage with Barclays for €973k. Chubb also knows about the Euromanx House guarantee to Slipway.
20 April 2007	PwC's IBR report is received. It does not mention money laundering or suspicious transactions. The existing CJS management team have been difficult, evasive and less than forthcoming with essential information.
25 April 2007	HBoS AGM Trading Statement.
1 May 2007	PwC are instructed to pursue an accelerated Mergers & Acquisition process (sale of the businesses). Turnaround consultant, Richard Bingham is approached to consider a cashflow monitoring and reporting role. Richard's proposed engagement is met with considerable resistance by existing management. Richard is a "seasoned-pro" and will undertake his own diligence at a granular level. The "intrusion" is not welcomed by CJS' management.
14 May 2007	HBoS Reading Incident becomes public knowledge following extensive media coverage.
31 May 2007	Richard Bingham's engagement is reluctantly agreed by CJS management for an initial period of 1 month. The scope of the engagement has been reduced by management from that originally intended by the Bank and PwC.

12 June 2007	KPMG commence a credit review audit of Reading connections.
30 June 2007	CJS management have not co-operated with Richard Bingham and are being difficult about renewing his contract after the 1 month expiry. They have also not assisted PwC in the AMA process.
July 2007	An offer is received from CJS' existing management team to acquire the shares in the 4 main operating subsidiaries. Although the offer is extremely low, in the absence of any other better alternative, the Bank decides to pursue the MBO option. In view of the potential MBO and no other offer likely, Richard Bingham's contract is not renewed.
1 August 2007	HBoS Half Year Results interim Statement. PwC and lawyers are involved in structuring CJS to enable the sale of the 4 main subsidiaries to existing management to complete via a day 1 insolvency process.
26 Sept 2007	PwC (David Chubb) appointed as Administrative Receivers of CJS. Principal subsidiaries are sold to CJS management's acquisition vehicle, Quest Aviation Services Ltd (Southwell and Shakesby are directors and shareholders; Mills is probably involved via Burwell Nominees). A considerable loss is crystallised.
19 Aug 2010	PwC (David Chubb) is appointed Administrators of Mint Partners. David Mills is Chairman. The founding directors have Clode Loans. There are potentially serious financial irregularities. A SOCA investigation is in course.

REPORTING OBLIGATIONS: INSOLVENCY PRACTITIONERS

Anti-Money Laundering Legislation

Under The Proceeds of Crime Act 2002 and Money Laundering Regulations, duly appointed Insolvency Practitioners and businesses providing accountancy and audit services are obligated to report to the Serious Organised Crime Agency when they have suspicion or reasonable grounds to know or suspect that a criminal offence, which gives rise to criminal proceeds, has been committed. This applies to any criminal activities involving the proceeds of crime.

Guidance on compliance with the anti-money laundering legislation for Insolvency Practitioners and for Accountants was published by the Consultative Committee of Accountancy Bodies in 2004 and 2003 respectively, with subsequent updates.

In relation to Accountancy Firms, the obligation to report applies regardless of whether the actual or suspected offence has been committed by a client or by another party. The report must be made as soon as practicable. The making of a report based on knowledge, suspicion or reasonable grounds for such takes precedence over client confidentiality considerations. Failure to comply with the requirements of either the Regulations or the Act can carry criminal sanctions.

Guidance provides that professional scepticism and judgement should be exercised when considering suspicious transactions and potential money laundering.

Insolvency Practitioners need to bear in mind that, where they suspect the assets of a company to which they have been appointed may be tainted by criminality, selling those assets without consent from SOCA may constitute an offence. Similarly if a Practitioner is suspicious that the funds offered to purchase a business or assets are of criminal origin, again he should obtain consent. Clearly there is scope for conflict between the duty to achieve the best results for creditors and the anti-money laundering legislation. However guidance suggests that the legislation will prevail.

Insolvency practitioners are subject to a number of specific reporting duties, including the requirement to submit reports on directors under the disqualification legislation. Under these various duties the matters to be reported and the nature and extent of the supporting evidence may differ from that required under the anti-money laundering legislation and regulations.

Section 218 of the Insolvency Act 1986: Dual Reporting to SOCA and The Insolvency Service

It is not the duty of a Liquidator or Insolvency Practitioner to investigate criminal conduct. However under section 218 of the Insolvency Act 1986, Liquidators have a duty to report any past or present officer [director] of a company, or any member [shareholder] of a company, if the Liquidator suspects that person is apparently guilty of an offence in relation to the company for which that person may be criminally liable. A Liquidator, who is an Insolvency Practitioner, is required to report the matter forthwith to the Intelligence and Enforcement Directorate of the Insolvency Service.

Although the statutory duty under section 218 of the Insolvency Act 1986 is specific to Insolvency Practitioners acting as Liquidators, best practice dictates that Administrators and Receivers are also encouraged to comply plus **all Insolvency Practioners have a public interest duty both as responsible Insolvency Practioners and as professionals to report criminal offences.**

Disqualification of Directors: Insolvency Practitioners Reports on the Conduct of Directors

Under the Insolvency Act 1986, the Company Directors Disqualification Act 1986 and The Insolvent Companies (Reports on the Conduct of Directors) Rules 1996, Liquidators, Administrators and Receivers are required to submit reports on the conduct of current and former directors (including shadow directors) to the Secretary of State for Business, Innovation and Skills via The Insolvency Service. Reports must be submitted within 6 months' of the date of appointment unless the conduct of a director is deemed to be unfit, in which event the report must be submitted forthwith.

Examples of unfit conduct include:

- Breach of fiduciary or other duties;
- Misapplication of assets;
- Trading whilst insolvent;
- Responsibility for the causes of insolvency.

The Insolvency Service will consider whether it is in the public interest for the Secretary of State to investigate and take action against directors. Action against directors is not limited to disqualification but may extend to criminal offences.

Investigations carried out during the ordinary course of an Insolvency Practitioner's work may uncover possible rights of action against directors, which the company, Administrator or Liquidator may have against third parties. Such rights include actions against directors for:

- Transactions defrauding creditors;
- Transactions at an undervalue;
- Extortionate credit transactions;
- Preferences (preferring one creditor ahead of another);
- Misfeasance and misapplication of property. [Liquidation only]

As well as the right of action, such matters are also required to be included when reporting on the conduct of directors. Criminal offences under the Insolvency Act and Companies Act are reported to the Insolvency Services Prosecution Unit.

The Enterprise Act 2002 made substantial amendments to the Administration process including extending certain of the rights of action to Administrators. Previously the rights of action vested in the company / Liquidator.

The rights of action carry certain time stipulations from the date of insolvency, which in most cases is **2 years prior to the date of insolvency**. Whilst the date of formal insolvency for Administrations and

Liquidations is the date of appointment of the relevant Insolvency Practitioner, in relation to Receiverships, a Liquidator must be appointed to formalise the date of insolvency. Receivers must be mindful to this and if there is evidence of a right of action then should take steps to immediately appoint a Liquidator, to "start the clock ticking". Any delay reduces the time period caught by the right of action. In simple terms if a Liquidator is appointed more than 2 years after a Receiver has been appointed then the right of action has expired or if the misfeasance happened 1 year and 1 month prior to the appointment of a Receiver and the appointment of a Liquidator is delayed by 1 year then the right of action will similarly have expired.

Public Interest Duty

Insolvency Practitioners are morally bound under their public interest duty to report and / or take action against delinquent directors where there is a reasonable prospect of success. Where there are no assets to cover the cost of action, then that moral obligation is usually underwritten by the chargeholder or bank, as being in the public interest.

SECTION TEN: THE TURNER CONNECTION

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PAUL & NIKKI TURNER / ZENITH COMPANIES

This section provides an understanding to the background of the Thames Valley Police investigation into the Reading Incident. The Turners concerns and tenacity had a pivotal role in establishing Operation Hornet.

The section is necessarily long to provide a comprehensive understanding into the themes and issues that are raised.

There are some serious matters for LBG to address. The Turners have been and are being unfairly treated.

CONCLUSION

Eviction of the Turners by LBG has been stayed through the intervention of the FSA in the Court process, pending the outcome of Operation Hornet.

It is difficult to understand the price that the Turners have been made to pay.

Their business was a start up, which was knowingly undercapitalised at the outset and got into the usual difficulties of start ups. They relied on Lynden Scourfield and Quayside.

All the evidence shows that they were crying out for an appropriate business manager. They acted in good faith and on the insistence of Lynden Scourfield provided £200k joint and several guarantees, which they collateralised against their dwelling house.

There is no one competent who can say whether or not that business would have been successful if they had been provided with appropriate consultants and proper assistance in securing third party investment.

They were financially naïve and looked to Lynden Scourfield. Lynden Scourfield and David Mills abused that naivety to a gross extent.

An initial meeting with the Peer Review team in March 2007 was badly handled. The director involved materially influenced decision making thereafter.

It is disappointing that Reading High Risk team members (David Hurst and Steve Gullon) were allowed to provide background information, which was not verified, subsequently augmented and

then relied upon by senior executives in their decision making. Having said that senior executives would appear to have had an entirely different agenda given the timeline of events in August 2007.

If the Turners had been treated properly in 2007 and subsequently in the first part of 2009, then who is to say whether or not they would have felt so compelled to bring their plight and the plight of others to the notice of those that they considered ought to know and who they thought might seek justice for them.

The toll on the Turners has been considerable. Mr Turner is in his sixties, he previously was of good health. He now has a serious stress related illness and is gravely ill. When he is able to eat he is on a strictly liquid diet.

Paul & Nikki Turner / Zenith: History

Background

Operation Hornet has its foundations with the Turners, who are victims of the Reading Incident and who from April 2007 repeatedly tried to bring their concerns and experiences to the attention of senior executives and then the Board.

The Turners are unusual in that they were successful in dispensing of the services of David Mills and Quayside, in early 2006. However the damage to the Turners at the hands of Quayside was largely done by that time and it prove impossible for the Turners to service the magnitude of debt that had amassed under Quayside's stewardship (it had increased by c.£800k, including fees).

The Zenith companies were in the music industry and were specifically record producers and music publishers.

The Zenith companies were effectively a new start-up in February 2003. The businesses were insufficiently capitalised at the outset. However, HBoS knew this. The business plan that formed the basis of the deal Credit Application showed a capital requirement that was 3 times that that was provided by way of SFLGS term loans.

Corporate provided facilities totalling c.£250k, the majority of which were SFLGS term loans. The Turners attempted to secure an investor in the business but that prove extremely difficult, not helped by their inexperience in such matters. The connections were referred to High Risk in August 2003. Lynden Scourfield took over the relationship role. In April 2004 he introduced Quayside as a condition of continuing support. Thereafter facilities escalated.

The Turners had operated their businesses from home. HBoS had historically provided a mortgage via Birmingham & Mid-Shires (c.£420k). Corporate lending in 2012 was c.£1.5m. The Turners also have a heritage overdraft of £20k with Lloyds TSB, secured by a second charge over the dwelling house. In May 2004 on the insistence of Lynden Scourfield, the Turners provided joint and several personal guarantees for £100k in support of increased Corporate facilities, secured by a third charge over the dwelling house, the PGs were increased to £200k in October 2005, again on the insistence of Lynden Scourfield.

The Turners were unable to service their mortgage and it went into arrears in 2006. Birmingham & Mid-Shires commenced possession proceedings in November 2006. Despite it being part of Quayside's role, they had not prepared any Management Accounts for the companies and the Turners by then could not afford the services of an Accountant. Quayside had further not introduced any potential investors, and despite positive commentary on the business from an industry specialist.

Quayside had invoiced the Bank directly for their "services" and Lynden Scourfield had processed payment without the authority of the Turners. That arrangement had continued after the Turners had dispensed with Quayside's services in February 2006 (Lynden Scourfield was aware).

Despite the lack of Management Accounts, there is considerable evidence to show that the Turners kept the Bank fully appraised of all developments in the business, invoices raised and debts outstanding. It is very clear that the Turners had needed a proper business manager / consultant. It is also very clear in the absence of one, the relationship they had with the Bank was a special relationship. They were obviously financially naïve.

HBoS High Risk and Impaired Assets: March 2007 to December 2008

On 26 March 2007 Andrew Scott was provided with evidence by a director in another Reading case to show fraudulent conduct, strongly suspicious of money laundering, amounting to £11m. The director alleged that Mills and Scourfield were responsible.

On 28 March 2007 the Turners had a scheduled meeting with Lynden Scourfield, which had not been cancelled on his suspension on 22 March 2007. Andrew Scott held the meeting and it is clear that it was difficult and not best handled. He was probably aware of that and the wraparound that was subsequently approved by Hugh McMillan, if it follows the misleading tack of subsequent notes, Emails and other file evidence, probably didn't properly represent the facts of the case. Hugh McMillan's response was or was effectively:

"Give it 4 weeks then call it up."

On 18 April 2007 David Hurst, who had become involved in the connection in the final quarter of 2006, appeared overly keen to persuade Tom Angus to make formal demand. There is no denying that the management of the banking relationship was time consuming, but that was the making of Lynden Scourfield.

At the time of David Hurst's exchanges with Tom Angus, the Turners were already in course of writing to Peter Cummings, and did so on 19 April 2007. David Hurst and Steve Gullon prepared a briefing paper for Peter Cummings, which Tom Angus copied to Hugh McMillan. The briefing paper misrepresented the facts and incorrectly portrays the Turners in a poor light.

On 15 May 2007 Hugh McMillan met with the Turners and agreed a temporary increased overdraft facility of £40k for 3 months and also agreed to refund Quayside fees that had been paid post February 2006. One of the conditions of support was the production of audited accounts for the 2 years ended 31 December 2006. The Turners made their complaints about Scourfield and Quayside clear to Hugh McMillan and Fraser Kelly, who was also present.

The Bank did not refund the Quayside fees. Income that was anticipated from the Turners' prime artist was delayed, additionally and is as normal in the music industry, contracts were delayed, and in the absence of the refunded fees, the Turners had no surplus monies to pay for Accounts to be prepared. The Bank had not been in contact and in the absence of an assigned RM, the Turners had liaised with David Hurst (a PwC secondee and close associate of Scourfield).

On 17 July 2007 Fraser Kelly wrote to the Turners asking for a progress report and expressing surprise that the temporary overdraft facility was more or less fully drawn. The Turners responded and explained that the fees had not been refunded as agreed. Fraser Kelly responded on 27 July 2007, and in his response he explained that he was moving roles and so they should contact Andrew Scott. The response asked for evidence to justify the refund, a matter which the Turners considered to be already agreed by Hugh McMillan with the information (fees invoiced directly to the Bank) already available to the Bank.

August 2007

In the intervening period the Turners had become aware of a number of irregularities relating to Lynden Scourfield and Quayside, and had undertaken their own inquiries. They had received no further update from the Bank in terms of their own complaints regarding Scourfield and Quayside.

On 6 August 2007 they wrote to Peter Cummings and Hugh McMillan. In their Email, there was a thinly veiled threat to go to the media.

On 8 August 2007 the Bank initiated the process to call up the debt. Customer Care sent out a response to the Turners' Email to Peter Cummings and Walker Morris was instructed to draft documentation. On 12 August 2007 Paul Turner was quoted in the Sunday Telegraph business section. On 14 August 2007 the Turners' responded to Customer Care. On 15 August 2007, Peter Cummings Emailed Hugh McMillan. On 17 August 2007 a new update was provided to Peter Cummings and the Press Office. Tom Angus had been involved in its drafting. It is misleading and does not present a true picture of the case.

What is disturbing is at that time, the Bank was fully aware of the fraud and probable money laundering that had been perpetrated across a number of Reading Incident cases. Evidence on the Reading Incident also shows highly questionable conduct by Scourfield.

On 22 August 2007 the Bank called up the Corporate debt and personal guarantees.

Possession and Eviction

The Turners' continued to try to find a way forward with the Bank. The Bank prevaricated with what in the circumstances (lack of funds) were unreasonable requests. The Turners continued to lodge complaints with the Bank and began to build up further evidence of Scourfield, Mills and Quayside related irregularities.

Between October and December 2007, there were various exchanges of correspondence, which are discussed below.

The Turners had and have been unable to secure legal aid and have had to represent themselves. They first defended Birmingham & Mid-Shires' action to obtain a warrant for possession of the dwelling house. The defence co-joins Corporate on the basis that it was the Zenith businesses that were the source of funding for the mortgage. An initial Court Hearing in October 2007 resulted in an adjournment of the possession application to April 2008 at which time the Court Order provided for a resolution of the dispute with the Bank, which involved the Turners having to lodge £50k in return for a new facility (no new Bank monies). Information on file shows that the bank considered that this was no a realistic proposition

In July 2008 the Bank increased the Zenith provision from £822k to £940k (Wraparound dated 30 July 2008). A Possession Order in favour of the Bank was granted in November 2008.

By the end of 2008 the Bank did not expect to make any recovery of the Corporate debt, including any recovery under the personal guarantees, and it was fully provided for (Wraparound 6 November 2008):

Referring to the Court Order: "The whole affair is a colossal waste of Bank time....."; and Recommending: "Meet with the Turners if, and only if, absolutely necessary...."

Up to that time the Turners' had been escalating their concerns within HBoS to a senior level and had engaged the support of a number of MPs, who had received similar representations from Reading Incident customers involving irregularities connected to Lynden Scourfield, Quayside and David Mills.

LBG

Corporate recovery action from January 2009

In November 2008 James Paice, representing himself and a number of other MPs, wrote to Lord Stevenson, the result of which was a meeting with Philip Grant and Andrew Scott on 27 January 2009. The Bank followed up the meeting by letter on 18 February 2009 including an initial offer as discussed below, and James Paice responded on 4 March 2009. The MPs raised issues including:

"We are concerned that by addressing the individual cases you are not addressing the bigger picture of Lynden Scourfield's involvement."

"We have considerable further evidence about other cases"

The compromise agreement on offer in February 2009 offered the Turners refund of Quayside fees totalling £65K, to be applied against the Corporate debt. In essence this offered them nothing.

The offer was subsequently amended in March 2009 and this is where LBG may have erred. The revised offer was made to James Paice and was not discussed with or explained to the Turners. The Bank then did not subsequently engage with the Turners or James Paice to ensure they understood the revised compromise agreement. Thames Valley Police have confirmed that the Turners have only ever referred to the refund of the Quayside fees as being offered by the Bank.

The letter that was sent to James Paice on 18 March 2009 provided for:

"BoS was prepared to credit the sum of £65k to Mr and Mrs Turner's mortgage account..."

"BoS was minded to write off the sums which are outstanding from the Zenith Companies."

James Paice had been seeking an amendment to the earlier offer such that the Quayside refund of fees was applied against the mortgage arrears. That was the expectation that the Turners were being managed towards by James Paice. James Paice copied extracts of the letter he received to the Turners. The second part of the offer may have "got lost in the translation" as it wasn't particularly clear if this was or wasn't part of the offer, and what the conditions were that attached to the rather unclear comment. It also didn't clarify the position regarding the personal guarantees. It might well be that the Turners didn't and haven't recognised the comment as being part of the offer. Unfortunately LBG did not engage with them or James Paice to provide clarification.

Redacted version as at 01/08/14 1400hrs

The following are extracts from an Email from Andrew Scott to Philip Grant on 16 March 2009 [redacted] It was written in course of drafting the revised offer letter to James Paice MP. At that time the offer that Philip Grant had suggested was **to refund Quayside fees of £65K, write off the Corporate debt and release the Turners from their guarantee** obligation in exchange for a compromise agreement. [redacted]

[redacted]

*(Mrs Freer's business had significant potential for success until the intervention of Quayside (Michael Bancroft). She signed a compromise agreement which released her from a personal guarantee of £600k, which she later contested as having been signed under duress. She won the case and the agreement was set aside. As threatened by Philip Grant in his letter of 18 March 2009, LBG then enforced the guarantee. She lost her home. She had 5 young children.)

James Paice responded to Philip Grant's letter of 18 March on 2 April 2009 and expressed concern at the Bank's stance. On 30 April 2009 Philip Grant responded and advised that if the offer was not accepted then the Bank would take forward the Possession Order.

[redacted]

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Our ref
2715/30911534
Your ref

Date
30 July 2014

UNUSED

Dear Mr Rowland

Operation Hornet

We are aware that you have been provided with a copy of a draft report produced by Sally Masterton, entitled "Project Lord Turnbull".

Lloyds Banking Group (LBG) does not consider it appropriate to comment generally on the accuracy or otherwise of any statements or assertions made, or conclusions drawn, in Ms Masterton's draft report. However, to the extent that it may suggest otherwise, LBG feels it ought to point out that the draft report was not commissioned by LBG. Rather, it was undertaken by Ms Masterton of her own volition.

We also note that page 121 of the report largely consists of legally privileged material. A redacted copy is enclosed. If this report is to be disclosed, we request that these redactions are incorporated.

Yours sincerely

Herbert Smith Freehills.

Herbert Smith Freehills LLP

Copy: Steve Butler (Disclosure Officer)

James Paice responded to Philip Grant's letter of 30 April 2009 on **22 May 2009**:

"your response is inadequate" "you are trying to buy off the "noisy" cases and ignore the wider issues" "at our meeting we were all of the view that the behaviour of Lynden Scourfield was highly questionable.....Your subsequent response was quite dismissive of that matter" "There are much bigger issues here.....which should be properly addressed by the regulatory authorities" "...concluded that the whole matter needs to be raised in Parliament and formal request made for official investigation.....I will outline the situation and the perceived lack of willingness by the bank to address the fundamental points."

The radio programme File on 4 aired on **26 May 2009**. The Hasard debate in the House of Commons was on **2 June 2009** and resulted in referral of the matter to the FSA.

On **8 June 2009** Philip Grant wrote to the Turners on Lloyds TSB letterhead and advised them that the Bank was taking steps to enforce its Possession Order. On **11 June 2009** LBG proceeded to enforce the Possession Order.

The Turners defended the eviction notice. Two further Court Hearings were adjourned, the last of these in December 2009 at the intervention of Hector Sants (FSA). At a further hearing in January 2010 all of the Bank's legal actions were set aside pending the outcome of the FSA investigation and any further criminal investigations relating to the Reading Incident i.e. Operation Hornet. This was again at the intervention of Hector Sants.

The Impairment Proposal Templates dated 21 February 2012 for Zenith Publishing Ltd and Zenith Café Ltd prepared by Steve Gullon confirm the following:

"In the light of the ongoing "Project Windsor" issues which have realistically evolved from this case..." "In view of the potential public prominence of "Project Windsor" issues, it is considered probable that all Zenith exposure will be written off by the Bank upon conclusion of the FSA, Financial Ombudsman and Police investigations." "No further action is considered appropriate against Mr & Mrs Turner."

The Turner Files

By **August 2007** the Turners had themselves compiled a large amount of substantive evidence to indicate strong suspicion of serious irregularities relating to the Reading Incident. After the Zenith debt and their personal guarantees (put in place at the insistence of Scourfield and Quayside) were called up on 22 August 2007, the Turners wrote to each member of the HBoS Board.

On 4 October 2007 the Turners again wrote to Lord Stevenson regarding their complaint and the other irregularities they had identified. Tom Angus responded. There was a further exchange of Emails in November 2007.

Having received no satisfactory responses, the Turners escalated their concerns to the Bank of England in September 2007 and then in November 2007 to the Prime Minister, the Chancellor of the Exchequer, the Chairman of the Treasury Select Committee, the FSA and to various MPs.

2008 Rights Issue

In view of the Bank's unwillingness to provide a senior platform to at least hear the Turners' concerns in relation to the Reading Incident, including the Turners' own treatment, the potential loss of their home and the culpability of Quayside and Scourfield for that loss, and the evidence of other financial irregularities that they had become aware of, in December 2007 they sought a counsel with their local MP, who was James Paice. James Paice wrote to Lord Stevenson on **11 December 2007**. By **19 March 2008**, Mr Paice had not received a response.

In **March 2008** the Turners provided further documentation in relation to the Reading Incident to Mr Paice and in **May 2008** Mr Paice wrote to Hugh McMillan, who had left HBoS by then. Andrew Scott responded and there was a short exchange.

On **23 May 2008** the Turners once again tried to engage with Peter Cummings. This time through the network of MPs a number of Reading victims had been identified and the Turners, having compiled potential evidence took it on board to represent the group. Denton Wilde Sapte responded on behalf of Peter Cummings. It would appear that for obvious reasons relating to disclosure matters the reply was somewhat dismissive and inappropriate.

Through to the Lloyds TSB Takeover

On **6 October 2008** the Turners wrote to the Prime Minister. Whether the Turners knew it or not but in one paragraph they identified what was known to all those involved in the deception:

HBoS had been insolvent for some time and that Going Concern issues unconnected to the financial crisis had been known about prior to the financial crisis.

On **18 June 2009** the Turners wrote to Eric Daniels. The letter contained sufficient substance to give cause for concern.

The Parliamentary debate brought forward potential new evidence and victims. The Turners wrote to Hector Sants on 3 July 2009. On 27 July 2009 the Head of Enforcement contacted the Turners and requested any further new evidence. On **4 August 2009** Greg Southall interviewed the Turners at length at their home.

On **19 October 2009** a summary report was submitted to the FSA by the Turners on behalf of a number of contributors. The report was subsequently sent to the Bank of England, the Treasury Select Committee, the EU Commissioners, the Prime Minister and other senior cabinet members. There were then various subsequent exchanges of Email. (The date of the Deloitte engagement letter is 23 October 2009.)

2010

In relation to the continuing Court actions to seek enforcement and eviction of the Turners from their home, Hector Sants provided a letter to the Court in January 2010, which resulted in a stay on actions pending the outcome of the FSA investigation and any subsequent criminal investigation.

In June 2010 Operation Hornet was formally launched.

SECTION ELEVEN: SUSPICIOUS MARKET CONDUCT

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MORGAN STANLEY: RIGHTS ISSUE JOINT UNDERWRITERS AND JOINT SPONSOR

Market Conduct Suspicion: 24 July 2008

Background

Morgan Stanley made a significant profit when it shorted 2.35% of HBOS immediately prior to the closing on 18 July 2008. It was widely expected that the subscription rate for the Rights Issue would be poor but not to the extent it was (8.3%). As long as a Chinese Wall was maintained between the trading desk and the HBoS relationship side of Morgan Stanley, which would know how badly the take-up had been, then there was no wrongdoing. The FSA cleared Morgan Stanley as they had been responding to orders from hedge funds, who were covering their own short positions.

(Better than expected news overnight from Citigroup had boosted the whole banking sector, so the HBoS share price briefly broke back through the rights issue price of 275p. Morgan Stanley (trading desk) shorted the shares on the premise that the positions would be covered by the underwriters' stick. It was a significant bet (£250m) but it was not implausible that the stick would be significant. The demand for the shares may have evaporated over the weekend if there was bad news on the financial sector, which was a strong possibility, leaving Morgan Stanley with a very significant stick. Noting that HBoS shares had been trading at below the Rights Issue price in the days before the closing. Morgan Stanley did not short HBoS shares at any time during the rights issue process, despite being allowed to do so, although it shorted other banks as proxies to hedge its exposure.)

Following the earlier placing of shares (£1.2bn: 29.5%) by Morgan Stanley and Dresdner (who didn't declare any short positions), meant that Morgan Stanley at the closing were still holding c.£750m, which was just below the 3% disclosable holding.

At that point in time, a number of hedge funds and City institutions were still sitting on very significant loss positions.

Prior to 24 July 2008 and the rumour, HBoS shares were trading at below the Rights Issue price of 275p, at 260p.

24 July 2008

On 24 July 2008 false rumours of a takeover bid for HBoS by Spanish Bank BBVA forced the HBoS share price to 305p (17%), allowing Morgan Stanley and Dresdner to sell more of the rump "overhang" and make substantial profit. At that time it was estimated that they had reduced their

combined position to less than 5%. The false rumour also allowed other hedge funds to close out positions, possibly generating large profits in doing so.

There is nothing wrong with the dealing as long as the market had not been manipulated. The source of the rumour may have been investigated by the FSA but has otherwise not been revealed.

BBVA was considerably smaller than HBoS, which combined with the declining property markets, financial crisis and rumours in the market place concerning the solvency of HBoS, and noting that the Interims were imminent, made the BBVA rumour unlikely but not implausible.

It should also be noted that HBoS' ordinary shareholders were meanwhile deprived of any proceeds that might have been made from the sale of the rights on their behalf.

EVENTS IN MARCH 2008

Coincidental Events Leading up to the Suspension of Shares on 19 March 2008

On 17 March 2008, Sir Callum McCarthy (Chairman of the FSA) telephoned Lord Stevenson.

On 18 March 2008, Lord Stevenson responded. Within his letter he expresses his concerns about malicious unfounded rumours from those with criminal intent to manipulate markets and create a "hit or run on an institution".

The comment doesn't refer to the telephone conversation they had had on 17 March 2008, and is strangely out of context.

Before the markets opened on 19 March 2008 a rumour circulated about HBoS having liquidity problems. The share price dropped by 17% before the FSA suspended shares and then make the unprecedented move of making a statement to quash the rumour.

A rather spurious story was spun, when on the previous Friday (11 March) Corporate colleagues were told that no new business was to be written whatsoever. It appeared obvious that capital and liquidity were an issue. The news was generally out there; it was not a secret.

SECTION TWELVE: POTENTIAL CLAIMS

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POTENTIAL CLAIMS

HBoS Shareholders

HBoS Shareholders may have potential claims in relation to the 2006 and 2007 Annual Report and Accounts, the Rights Issue which completed in July 2008, other information announced on the Stock Exchange from potentially January 2007 and, albeit remote, the November 2008 Open Offer and Placing

Shareholders may have claims against KPMG.

Lloyds TSB Shareholders

Lloyds TSB Shareholders may have potential claims the liabilities for which are complicated.

It is highly probable that the acquisition of HBoS would not have proceeded if the Reading Incident had been disclosed.

Lloyds TSB shareholders may have potential claims in relation to misleading statements and omissions in the HBoS 2007 Annual Report and Accounts, the Rights Issue Prospectus and the 3 November 2008 and 12 December 2008 Trading Updates, as included in the Lloyds TSB Circular, Prospectus and Supplementary Prospectus.

Additional investigation is required regarding the inquiries made by Lloyds TSB in October 2008 following receipt of evidence from a Lloyds TSB customer of potential financial irregularities relating to the Reading Incident, which should have given rise to cause for concern. Lloyds TSB acknowledged receipt.

Additional investigation is required regarding due diligence carried out by PwC in November and December 2008, and in particular with regard to whether or not PwC were provided with the full Corporate Credit Committee reports.

The loss to Lloyds TSB shareholders resulting from the acquisition has been estimated at £14bn.

Reading Incident Customers

When considering potential claims of customers against the Bank, it must be first established whether or not additional facilities advanced and / or the engagement of QCS gave those customers a reasonable chance of surviving. There are so many intangibles that it is doubtful whether there is any competent authority who could opine on this aspect.

Similarly for those businesses where customers effectively lost control it is unlikely that it can be established whether loss of businesses and hence income, or additional personal monies injected after the introduction of Quayside, or personal guarantees ultimately called up and settled, is loss either wholly or in part, attributable to the actions of Lynden Scourfield and/or Quayside, which otherwise would not have crystallised if the businesses had been left under the stewardship of these customers.

A factor which will also be taken into account in assessing compensation claims is how diligent the Bank has been in uncovering the fraud and money laundering.

The situation is also "muddied" with regard to time limits for bringing actions, and also with regard to the criminality aspects.

READING INCIDENT LEGAL COMPLEXITIES

Good Faith

The potential claims of the victims of the Reading Incident are legally complex. This is compounded by a lack of formal documentation e.g. facility letters and Bank correspondence, QCS engagement letters and / or agreed terms of engagement, the nature of the relationships between QCS, Lynden Scourfield and HBoS, and not the least the fraud and money laundering aspects.

Key considerations must be the relational aspects and Scourfield and others' abuse of trust.

HBoS also made false representations in relation to David Mills and QCS, and as such the victims should be entitled to damages for misrepresentation on the basis that HBoS had induced (in fact unfairly influenced through threats) the victims to unwillingly consent, without separate legal counsel, to the engagement of QCS and the subsequent course of events.

The observance of reasonable standards by HBoS in relation to business conduct that was not improper, commercially unacceptable or unconscionable, should at the time been key aspects of good faith. Clearly such standards were not observed.

The relational aspects here go far beyond what is a normal and reasonable banking relationship, even when the customers involved were within the High Risk arena. These were not impaired customers but customers, which the Bank was supposed to be heavily involved in "turning around". Noting of course the prevailing direction from the Board of avoidance of impairment and non crystallisation of loss, which within Reading and for David Mills and associates, meant criminal opportunity.

YES THEY WERE

Undue influence and duress in the context of the Reading Incident are commented upon in more detail below. Both are an abuse of unequal bargaining power.

Threats to withdraw funding and /or instigate Insolvency proceedings affect customers' decision making. There are of course other factors relevant to the Reading Incident cases. There is evidence to strongly suggest that there was coercion of will so as to vitiate consent.

Undue Influence

No court has attempted to define fraud and no court has attempted to define undue influence. Both are assessed on the facts of the individual cases.

Ordinarily the presumption of undue influence would not apply between a bank and customer, for the reasons explained below. However the circumstances of the Reading Incident are so unusual, beyond normal reason and "manifestly disadvantageous" to the victims, that undue influence must be considered.

Given the elapse of time then ordinarily the statue of limitations would apply. However HBoS was on notice of misfeasance, fundamentally inequitable treatment of customers, suspected money laundering and the gross misconduct and involvement of HBoS employees as far back as January 2007, if not much earlier.

To prove undue influence there must be evidence to show:

1. Capacity to influence;
2. Influence was exercised;
3. Exercise was undue; and
4. Exercise brought about the transaction.

THIS IS WHY I BELIEVED HE WAS FULLY AUTHORISED

What is clear is that Lynden Scourfield, with the apparent authority of the Bank (which Philip Grant has committed to writing), established a special relationship with the Reading victims. A special relationship gives rise to a presumption of influence only but not undue influence. If the relevant "transaction" in question is suspicious (which again is extremely relevant to the Reading Incident) then a second evidential presumption, of undue influence will arise.

Even in the unlikely event that it is considered that no special relationship exists then the relationship can be nevertheless one of "trust and confidence", where one party is in a position to exert undue influence over the other. The victims must show they placed trust and confidence in Scourfield / the Bank.

Whether Scourfield and others applied unacceptable pressure will depend on the merits of each case, however it must be proven that the will to resist had be worn down. In relation to certain of the Reading cases, Fleming J could well have been thinking about them when he likened "the difference between legitimate persuasion and excessive pressure, like the difference between seduction and rape".

There is also the highly relevant issue of concealment of material facts by Scourfield and others, the effects of which would be known by Scourfield and the others e.g. QCS' excessive fees, QCS' lack of proven track record (or in actual fact abysmal track record), and QCS' and Scourfield's true motives. Failing to disclose all material facts impairs autonomy of free will because it prevents a fully informed decision, which Scourfield combined with excessive pressure. In this context there is of course the overlap of the separate grounds of undue influence from concealment of material facts and fraudulent misrepresentation.

Undue influence may be rebutted on the basis that the "weaker" party exercised independent free will. However it must additionally be proven that the "weaker" party fully understood the transaction and that the transaction that was entered into was as intended. This latter point has to be severely questionable as it would appear that there may be grounds for fraudulent representation.

In addition the Courts take a strict view with regard to reasonable alternatives, even if those might be unpalatable. This latter point may be highly relevant to Reading Incident cases but each case must be assessed on the basis of its own merits.

Duress

Duress occurs where there is abuse of position by the dominant party and thus of the trust and confidence reposed in that party such that the act of contracting by the weaker party is not a voluntary act. Additionally the dominant party must be acting in bad faith (illegitimate pressure) and the pressure must be significant.

Duress therefore encompasses undue influence, duty of care, fiduciary obligations and good faith.

Where duress involves threats to engage in a legal process e.g. Insolvency action, although in some circumstances this may be lawful, it will always be unlawful if the threat was made in bad faith. There is also the case that what is being threatened is a legal wrong.

Transactional imbalance is compelling evidence that duress has been exercised.

It has to be considered whether the victim had any realistic practical alternative but to submit to the pressure and also whether the victim protested at the time.

The difference between undue influence and economic distress (where the parties are already in a contractual relationship and the abuser takes advantage of the plight of another) is that undue influence involves psychological pressure whereas economic duress is the use of economic pressure. An important distinguishing factor is also that it is the common law doctrine of distress whereas the equitable doctrine of undue influence.

In relation to the Reading Incident, the victims appear to have been deprived of the power of choice through the threats that were made by Scourfield and others in abuse of their positions. However for each case there had to have been an assessment by the customers of the seriousness of the risk of enforcement against the potential benefits of accepting the risk. This is by no means straightforward when personal guarantees are involved.

Taking the reasonable man argument, on balance there is a strong argument that the Reading Incident victims would not have entered into the transactions forced on them by Scourfield and QCS. Those transactions are therefore wrongful in the sense that one party was victimised by another.

Fiduciary Duty of Banks

Both undue influence and duress have a fiduciary element as well as underpinning the duty of good faith.

Historically case law provided that a bank has no duty of care to any of the other parties involved in the lending contract, and in particular in relation to how the bank reaches the decision on how to recover its debt. This is the general principle that no duty of care exists between a debtor and creditor.

As banking has become more complicated, case law is adapting.

The general principle of law is also that customers are responsible for their own choices and accordingly, there is no general obligation for businesses to protect their customers from making unwise choices.

The function of fiduciary law in basic terms is to act as a deterrent against cheating.

Banks until relatively recently in history were partnerships. It may be an old fashioned view, but those roots made bankers risk averse and focussed on the long term needs of their customers, to whom they had open ended liability. Fiduciary or not, this forced honesty in the system.

A fiduciary duty is a legal relationship between one party, the principal, who is dependent on the better knowledge and judgement of the person he trusts, the fiduciary. A fiduciary duty is the

highest form of duty and contrasts with the ordinary tort duty of care, which seeks only to avoid harm.

There are four situations, which have been identified in which a banker may become a fiduciary in relation to its customer:

1. Receives or transfers funds of its customer;
2. Gives advice where it is in a position of conflict of duty and interest;
3. The banker is in a special relationship with its customer and is in a position of conflict of duty and interest;
4. Where a bank makes a mistaken payment to another.

In relation the special relationship situation, it must be shown that the customer relies on the bank and the bank is aware of that reliance, and there is a relationship of confidentiality.

The basic remedies for breach of fiduciary duty are far more favourable and include equitable compensation. In addition equitable remedies and claims for equitable remedies are not time barred by the Statute of Limitations in the way that common law damages are.

A common law fiduciary duty is an obligation to act in the best interests of another party giving rise to a complete loyalty to the service of another's interests. This duty has several facets:

- A fiduciary must act in good faith;
- He must not make a profit;
- He must not place himself in a position where his duty and his interest may conflict;
- He may not act for his own benefit or the benefit of a third person.

Significantly for the customer, this relationship imposes a more extensive duty of care than found in tort. Established categories of presumed fiduciary relationships include agent and principal, solicitor and client, and doctor and patient, although the Court can impose a duty in any relationship subject to the facts of a case.

In Woods v Martins Bank Ltd the Court accepted that a fiduciary relationship was born where a bank manager acted in an advisory capacity. The reliance upon the advice and expertise of a bank by a customer can create fiduciary obligations, however the imposition of such duties by the Court ultimately depends upon the facts of each case.

There is great difficulty in importing an equitable doctrine into the law of commerce. However common law merely requires honesty, diligence and performance of contractual obligations, but equity requires nobler qualities of loyalty, fidelity, integrity and respect for confidentiality, which are positive requirements reflected in the complexity of modern day banking.

Fiduciary Duty considerations applied to the Reading Incident

Banks will always argue that a bank has no fiduciary responsibilities towards its customers and acts purely in a contractual relationship. As such any suggestion of an implied duty to take reasonable care when dealing with a customer will by rejected.

The Reading Incident is however extremely complicated and the actions of HBoS went considerably further that a normal "High Risk / Impaired Asset" relationship or a banker / customer (debtor / creditor) relationship. In doing so HBoS failed to exercise the level of skill, integrity, honesty and care that it was reasonable to expect of a competent and regulated banking organisation.

It should always be remembered that it has to be strongly contended that HBoS would act fairly as a creditor and in good faith to the ultimate Reading Incident victims. HBoS clearly did not and further exacerbated the loss and distress ultimately suffered by many of the direct and indirect victims.

Some comment needs to be made about David Mills and other QCS "consultants" and the capacity under which they were acting. There are obvious issues relating to their conduct and duties as directors to the Reading Incident companies to which they were appointed. There are also "shadow director" issues, where Mills and associates had executory powers or otherwise acted in a managerial capacity in relation to the Reading Incident cases, but there were no formal directorship appointments. Both of the foregoing should have been considered and adversely reported upon by the Insolvency Practitioners, who were appointed to Reading Incident cases. The Bank's involvement in those appointments, the executory powers imposed and subsequent granting of increased facilities exposes the Bank to significant risk. The relationship between QCS and HBoS is one that requires specific legal opinion, which should encompass consideration of the duty of care, fiduciary duties and other duties QCS owed to the victims of the Reading Incident, given the Bank owed a duty of care to the victims when imposing the "services" of QCS and David Mills onto the Reading Incident victims.

There is also the complication of "asset stripping", excessive fees, leakage of significant additional facilities post involvement of David Mills and QCS.

There are a number of other considerations:

- The criminal conduct of HBoS employees;
- The otherwise complicit involvement of HBoS employees including those in an oversight function;
- The complicity and misconduct of KPMG;
- The delinquency / misconduct of senior executives and the Board of HBoS;
- The actions of HBoS and the Insolvency Practitioners post formal "discovery" in January 2007.

Liability for Employee Misconduct

An employer is vicariously liable in tort for the wrongful acts of its employees committed during the course of their employment, where they are acting on the employer's behalf. Responsibility extends to the costs of the misconduct.

While on the face of it, as was the basis of historic case law, no employer employs an individual to be dishonest or to commit crimes, case law now extends to cover any fraud which is closely related to an employee's employment. The defrauded individual or company must have been assured or led to believe by the employee or have inferred through course of dealing, that the employee had authority.

APPENDICES

APPENDIX I

A BRIEF SYNOPSIS OF THE HISTORY THAT GAVE RISE TO THE HORNETS' NEST

This section provides inside knowledge of the culture and dynamics of Bank of Scotland into HBoS and through to the ultimate demise of HBoS. It explains the motivation and importance at Board level for keeping the Reading Incident concealed.

In essence it can be summarised by the following:

The Bank of Scotland culture became a necessity for HBoS:

"A primary focus on controlling absolute levels of loss." Executive Committee: 17 May 2005; Board Meeting: 27 May 2007 *"It could be disastrous if market sentiment moved against HBoS."* Executive Board : October 2007

At a basic level, if the Reading Incident had been properly disclosed in the 2007 Annual Report and Accounts then it is unlikely that the Rights Issue would have been capable of proceeding and irrespective of whether the Government stepped in or not at that time to prevent the collapse of HBoS, it is unlikely that the acquisition by Lloyds TSB would have occurred.

The following synopsis provides a "cradle to grave" account:

The Fallacy

In 1999 "new Corporate" came into being in Bank of Scotland and marked a sea-change; positioning itself towards highly leveraged, equity and structured deals. It was at this point in time that the die was cast.

In the 1990s large problem deals had been contained in-house avoiding insolvency and crystallisation of loss through restructurings involving equity participation, debt / equity swaps, debt rollovers and use of other vehicles through which increased funding was provided, or alternatively increased facilities, which also lacked credit fundamentals, were provided. The deal sizes were

relatively small in today's terms. The Bank of Scotland favoured a growing number of "entrepreneurs" with alleged (unproven) turnaround success.

Bank of Scotland's culture was resistant to recognition of distress and was strongly averse to impairment and crystallisation of loss. The business was incentivised to restrict impairment.

The Merger

Under HBoS and the high risk business strategy that was pursued, which involved a significant and increasing funding gap, the culture of non recognition of distress and impairment became a necessity. It was an inherent part of the business model. The practice was formalised and known.

The HBoS merger strategy was predicated on market sentiment. The high risk strategy was known to the market so HBoS had to deliver and outperform. To do otherwise would result in downgrades of external ratings, impacting on the cost and availability of wholesale funding and possible loss of deposits, and also impacting on regulatory capital. The strategy needed to create the illusion of a strong capital base, minimal impairment and robust credit quality. The share price was additionally artificially manipulated through the HBoS programme of returning capital to shareholders and generous dividend policy.

At an early stage High Risk was concerned at the dependency on property values, the risk profile of deals and the level of entrepreneurial lending. Argument to dispel was always centred on the substantial income that was being generated combined with, what was a weak contingency plan in the event of a market shift, being the Bank taking a holding position and not crystallising loss. The relative size of the deals compared to the 1990s was dismissed.

Additionally any argument to demonstrate the sheer magnitude of income generation that was necessary to balance against potential loss within the joint venture and integrated finance portfolios alone (i.e. it takes a lot of fees to plug a hole), was dismissed or simply ignored.

KPIs were aggressively set to incentivise against distress and impairment.

The BoS culture had become a necessity in HBoS.

Crisis Time

By 2005 the group situation had become untenable. Retail was struggling and known to be struggling. The Board in full knowledge of the risk profile in Corporate placed reliance on Corporate to compensate and provide profit and capital through realisation of investments. The reliance wasn't hidden, it was overt and created elitism within Corporate. Credit risk and market risk were given scant regard in larger deals.

Credit was removed from front line competencies.

Simply to stand still required over £20bn of assets that had to be written each year. There had been little progress in winning SME market share in England and Wales. Senior executives within Corporate, the Executive Board and the Board were all fully aware of the risk profile of the portfolio and its dynamics. Performance in Corporate had become predicated in particular on key contacts, "the Group's extended family of entrepreneurs", and the integrated approach. The Corporate model and portfolio was fragile having a dependency on corporate finance deals (which are typically cash flow lends) and commercial property.

Within Risk and Credit there were serious concerns. It was considered unlikely that Corporate would be able to trade out of a prolonged downturn in property markets without some significant "hits".

2006 – The Beginning of the End

George Mitchell announced his successor in mid-2005, Peter Cummings. George Mitchell had been strongly resistant to Basel II intrusion and the project was significantly behind plan. Peter was tasked with delivering the Advanced IRB approach waiver for Corporate. It was utter chaos.

The churn in Corporate was increasing, which put even more weight on entrepreneurial, joint venture and leveraged deals. On entering 2006 a correction in the property market was expected but within HBoS, Corporate was under pressure to deliver. Riskier deals were written, including significant secondary retail property deals in Europe. Capital, liquidity and the funding gap had always been a significant risk but the situation was becoming critical. Impairment and distress were clamped down further to maximise Tier 1 capital. It was absolutely essential for HBoS to achieve Advanced Status under Basel II from 1 January 2008 and thereby benefit from the significant reduction in Retail's risk weighted assets (c.£50bn) and the effect that had on regulatory capital. No secret was made of this.

In June 2006 everyone was clearly alert to major economic risks and the developing situation in the USA.

Peter Cummings established the Causality Team in Spring 2006. Corporate High Value cases that migrated into High Risk and Impaired Assets were investigated. They were largely severely distressed on migration. Operational risk was prevalent (including marking of Limits on CBS) and credit risk management and assessment were largely poor. KPMG did not make enquiries of the Causality Team as part of their audit work.

Tom Angus (Head of Impaired Assets)

Evidence suggests that the Reading Incident was known about well before 2006. However it would appear that Tom Angus on taking up a new role as Head of [High Risk and] Impaired Assets discovered irregularities in August 2006, that later in January 2007 became known as the Reading Incident. The timing of January 2007 is suspicious and may have been to avoid disclosure in the Annual Report and Accounts 2006. The share price at that time was £10 - £11, and although the

impacts of disclosure would have been substantial, HBoS might have survived the impacts at that time (February 2007).

As explained above, the dynamics of the business were in crisis. The mortgage market had changed dramatically since the merger. The Corporate model and portfolio were of serious concern. The only real light on the horizon was the significantly reduced regulatory capital requirement under Basel II Advanced Status and it was essential for survival for this to be attained. All, including KPMG, were fully aware.

In view of Tom's appointment and the data cleansing exercises, which were exposing Reading Incident cases, **there is evidence to suggest that Paul Burnett, Lynden Scourfield and others were attempting to "hide" Reading Incident cases where there is significant suspicion of money laundering.**

The models that were being introduced into Corporate for Basel II necessitated reconciliation of data, which threw out exception reports resulting in a prolonged data cleansing exercise. Due to the importance of Advanced Status, Peter Cummings had a hands-on oversight role in data cleansing, which fed into all HoFs. The balance of evidence would suggest that Tom Angus strongly suspected irregularities in Reading by June 2006, and that through data cleansing exception reports, Corporate Jet Services Limited and other "hidden" Reading Incident cases had been identified. It would appear that Peter Hickman may have disclosed to the Executive Committee on 31 October 2006 that irregularities in Reading had been identified by Tom Angus.

Concealment

In June 2006 and subsequently, the Board would not want to recognise a £1bn Impairment Provision. Potential Reading issues were and had been prominent within Corporate Credit Committee Reports. Sir Ron Garrick chaired the divisional Risk Committee, which attended CRC meetings and otherwise received copies of reports and Minutes in relation to the CRC.

There is evidence to suggest that there was deliberate avoidance of review and audit of MV High Risk connections by Group Credit Risk, GIA and KPMG, none of whom prior to 2007, and despite the relative size of the Reading High Risk portfolio, had reviewed or audited Reading High Risk cases (with the exception of 2 connections in early 2005). KPMG would be fully aware of the underlap between their work and that of Group Credit Risk in relation to MV High Risk connections.

The Reading Incident was reported to the FSA in March 2007 as a control issue, after the 2006 Annual Results had been announced. On 26 March 2007, the Peer Review team who had been brought in to Reading were provided with strong evidence of money laundering amounting to £11m, involving a number of Reading High Risk cases and David Mills / Quayside. **Criminality was not reported through SARs and was not reported to the FSA . The Peer Team had previously become aware of significant suspicious transactions totalling over £20m on 22 January 2007.**

A final report was subsequently provided to the FSA around the time the Interim Results were announced on 2 August 2007, and the party line of the Reading Incident being a fundamental breakdown in controls at Reading perpetrated by one individual, Lynden Scourfield, with no financial crime implications, was upheld.

It was a "whitewash" exercise; the first of a number. The FSA were seriously and deliberately misled.

KPMG and Group Credit Risk had undertaken significant investigation, and knew that the report submitted to the FSA was incorrect and deliberately misleading. This timing coincided with the securitisation and syndication markets closing and wholesale markets tightening. It was the real beginnings of the financial crisis in the UK.

The End

In February 2008 the Annual Report and Accounts for 2007 were announced. The Accounts had been prepared in contemplation of the Rights Issue, which had been strongly influenced by the FSA after they had approved Advanced Status under Basel II.

Disclosure of the Reading Incident at that point in time would in all likelihood have precipitated the collapse of HBoS.

On 29 April 2008, the Rights Issue was announced. The Prospectus was published on 19 June 2008 and on 18 July 2008 the Rights Issue closed. Interim Results for 2008 were announced on 31 July 2008. During this period the Corporate stressed portfolio had grown considerably but was not disclosed to shareholders or the City. Meanwhile the FSA had grave and growing concerns regarding HBoS, which appear to have started in September 2007, when coincidentally they were first furnished with third party evidence to suggest serious irregularities regarding the Reading Incident.

On 17 September 2008 the acquisition by Lloyds TSB was announced. Lloyds' Circular was published on 3 November 2008 and both Prospectuses were published on 19 November 2008. There had been significant growth in Corporate's stressed portfolio, **which at that time was reported to the CRC (and divisional Risk Committee) as being £40bn. This was not disclosed in the Prospectuses or subsequent Supplementary Prospectuses, which were published following the HBoS 12 December 2008 Trading Update.**

At a basic level, if the Reading Incident had been properly disclosed in the 2007 Annual Report and Accounts then it is unlikely that the Rights Issue would have been capable of proceeding and irrespective of whether the Government stepped in or not at that time to prevent the collapse of HBoS, it is unlikely that a solvent acquisition by Lloyds TSB would have occurred.

APPENDIX II

MISLEADING STATEMENTS IN ANNOUNCEMENTS, UPDATES, PROSPECTUSES AND ACCOUNTS

1 August 2007 Interim Results Announcement

Note: HBoS' share buyback programme and dividend policy were deliberately designed to inflate the share price. The directors and KPMG knew that capital was overstated through the non recognition of distress. Irrespective of that, capital was scarce and was sacrificed to give a false impression to shareholders and investors.

- "Corporate credit quality remains robust.
- In particular, given the potential for reduced liquidity in the secondary markets, we continue to underwrite and price our originating activity on the assumption that we would be comfortable holding the business on our balance sheet if required to do so.
- Our view on the importance of capital discipline and efficiency at HBOS is unchanged. We will complete our £500m share buyback programme this year. In addition, today's 23% interim dividend increase demonstrates how our capital discipline and efficiency is translated into a higher payout ratio for our shareholders. Above all, today's dividend increase points to the confidence we have in our future.

Prospects

- Our strategy is one of measured growth, strong returns, and sound credit quality, with a focus on increasing noninterest income in order to generate significant and sustainable shareholder value.
- Revenues from our investment portfolio have been exceptionally strong in the first half of 2007, and may not be repeated in full in the second half. Nonetheless, we remain confident that overall 2007 will see a substantial increase in the contribution from our investment portfolio and that the portfolio is well positioned to sustain its contribution to earnings in future years."

13 December 2007 Pre-Close Trading Statement

Group Overview

- Robust credit trends; Group-wide credit trends remain robust.

Andy Hornby, Group Chief Executive, commented:
"Asset growth has been stronger in the second half than in the first half. Higher levels of lending growth in Corporate *(no where was it explained why)* and a lower share of mortgage principal

repayments in Retail are set to lead to a stronger than forecast level of asset growth for the Group for the full year.
Non-interest income has been maintained at a similar level to the strong performance of the first half. It is thus expected to make a healthy contribution to full year revenues. "

Outlook

- "The Group expects to deliver a good full year outcome, in spite of the significantly changed environment in the second half arising from current market liquidity conditions.
- In the short term, we expect the global market dislocation to continue and we will remain prudent in our approach to lending. "

Annual Report and Accounts: 2007

(Preliminary announcement 27 February 2008)

[The Rights Issue, influenced by the FSA had already been decided.]

"The Chairman's lot is a happy one when, as last year, the Annual Report can laud a share price out performance both against the FTSE 100 and the FTSE Banks index. Not so in 2007, where our share price fell some 35%, a performance that was in the middle of the pack, but of little consolation for a bank that seeks to outperform. This year's report will therefore examine with our usual frankness the performance in 2007 and the strategy we are pursuing for our shareholders in 2008.

Market dislocation

- If ever the boards of banks, regulators or rating agencies needed a reminder of the importance of strong liquidity and strong capital, the second half of 2007 served as a wake-up call. Seemingly overnight, we moved from a scenario where the economic cycle looked set to play out in a relatively benign way, to one where a credit crunch in the USA rapidly deteriorated into what is, as I write this, a worldwide liquidity dislocation. Banks now know, as in truth they always did, that first and foremost, it is the duty of the Board to ensure that the Group has financial stability and the wherewithal to continue in business profitably.
- For 2008 we will continue to pay careful attention to the importance of both strong capital and strong liquidity and to size our balance sheet to the certainty of both."

Chief Executive's Report

- "In our Corporate business we continue to concentrate on markets where we have real expertise and can generate superior returns.
- We accept that capital is owned by our shareholders who expect us to treat it as a scarce resource,.....capital strength is also required to cushion against the shocks that are a periodic feature of banking.
- During 2007, the FSA approved our Advanced Measurement Approach ('AMA') operational risk and Advanced Internal Ratings Based ('AIRB') credit risk waivers. This advanced capital

regime has redefined both the size and nature of the capital resources available to HBOS as well as the level of risk weighted assets. It has not however changed our approach to capital management.

- However [in Corporate], we continued to approach the market selectively, and despite slower secondary markets we continued to sell down to hold levels with which we are comfortable.
- We are planning on the assumptions that market conditions will remain uncertain throughout 2008. For our Treasury & Asset Management division, the key focus for our Treasury team is the management of our funding and liquidity during the financial markets dislocation. We entered this period confident in our funding profile and capital base. This has served us well and we intend to maintain robust liquidity and capital positions going forward. "

Corporate Strategy

- The key aspects of our strategy to deliver our overall objective are: Selective asset growth, whilst preserving strong margins and exercising vigilant credit risk management

2007 Performance [Corporate]

- Credit quality remained sound in 2007 although defaults were at a higher level than the historically low figures seen in 2006. ***[The considerable impact of the Reading Incident is not explained.]***

Risks and Uncertainties [Corporate]

- To mitigate this, we back property entrepreneurs who have a track record of operating through the economic cycle.
- Our commercial real estate exposures are not secured primarily on the value of the collateral but on the strength of the underlying cash flows of the businesses we back.

Prospects [Corporate]

- The corporate sector in the UK remains relatively under geared and companies are generally well placed to service increased debt costs.
- Our commercial property portfolio is expected to continue to perform relatively well, partially reflecting our preference for incremental growth in Europe. ***[Secondary commercial property was targeted.]***
- In an environment where commercial property prices are expected to remain under pressure our primary focus on cash flow based property transactions, with collateral valuations as support, will continue to drive our risk based decisions.

Corporate Governance Comply or Explain Statement

"The Company considers that it has complied throughout the year with all of the provisions within section 1 of the Code, other than provision C.3.1 which recommends that the Audit Committee should comprise solely independent Non-executive Directors....."

Going Concern Statement

"The Directors are satisfied that the Group has adequate resources to continue in business for the foreseeable future and consequently the going concern basis continues to be appropriate in preparing the accounts."

29 April 2008 Trading Update and Announcement of Rights Issue

"Background to and Reasons for the Rights Issue

The Board of HBOS believes that a stronger capital base is appropriate in current market conditions. The four key objectives of the capital raising are:

- to rebase the Group to stronger capital ratios;
- to consolidate the Group's strengths in its core markets;
- to mitigate the increased sensitivity on our regulatory capital of change arising from Basel II; and
- to accommodate the impact of the Treasury portfolio fair value adjustments.

The Board is optimistic about the fundamental prospects for the Group's core businesses. The enhanced capital position will enable the Group to pursue its strategy of.....delivering measured and selective high value Corporate growth....."

Trading Update

"This trading update constitutes the HBOS Interim Management Statement for the period from 31 December 2007 to 28 April 2008.

This announcement covers the information to be presented at the HBOS Annual General Meeting in Glasgow and discussed in a presentation for analysts and investors at 9am today.

Group Trading Overview

- Competition for deposits has been strong but we expect to grow deposits at a faster rate than assets in the year."

Outlook

- "The capital raising announced today will provide us with financial resilience in challenging economic circumstances.
- We expect only a modest increase in impairments and will continue to drive costs out of the business.
- We are focused on achieving returns on equity in the mid teens, and are well placed to deliver long term sustainable growth."

19 June 2008 Trading Update

(as contained in the Rights Issue Prospectus)

[There are a great many misleading and untrue statements and inconsistencies.]

"This trading update covers the period from 1 January 2008 to 31 May 2008 and updates the Interim Management Statement published on 29 April 2008."

GROUP TRADING OVERVIEW

- "Trading continues to be satisfactory.
- While HBOS is not immune from the global dislocation in financial markets that is impacting the wider economy and credit conditions, it is on track to demonstrate a resilient performance in 2008.
- In Corporate we are seeing improved pricing but adopting a cautious approach, and slowing asset growth.
- We expect to maintain strong capital ratios and, after the rights issue, the Tier 1 ratio is expected to be within the range of 8% to 9% and the Core Tier 1 ratio between 6% and 7%.
- In a more difficult trading environment, HBOS expects a resilient performance in 2008, which will provide a sound platform for the future.

Corporate

- In a slower growth environment we have also planned for lower returns from our Corporate investment portfolio.
- Lending secured on commercial property investment is based primarily on the quality and diversity of tenant covenants and cashflows.
- Lending and investment in the housebuilding sector at the end of May 2008 totalled £4.2bn (Dec 2007 £4.0bn), of which £3.5bn was provided in senior debt, £0.3bn in mezzanine, £0.3bn in loan stock and £0.1bn in equity finance. The HBOS housebuilder exposure is mainly to niche sections of the market (including retirement housing, the affluent, urban regeneration and social housing) rather than volume led operators. At this point in the cycle, whilst housebuilder earnings are projected to fall, thereby impacting interest cover, debt safety is underpinned by collateral values including landbanks."

Rights Issue Prospectus 19 June 2008

[Contained 3 years' audited financial statements ended 31 December 2007 and disclosures 2007 with comparatives; 19 June Trading Update.]

Background to and reasons for the Rights Issue

- "On 29 April 2008, the Board of HBOS announced the Rights Issue and the Capitalisation Issue. The Rights Issue is intended to raise £4.0 billion (net of expenses), to strengthen the Group's capital base.
- Together with the establishment on 29 April 2008 of a new target Tier 1 ratio of between 8.0% and 9.0% and a new target core Tier 1 ratio of between 6.0% and 7.0%, these actions will achieve a step change in the capital strength of the Group.
- The Board believes that a stronger capital base is appropriate in current market conditions. The four key objectives of the capital raising are:
  (a) to rebase the Group to stronger capital ratios;
  (b) to consolidate the Group's strengths in its core markets;
  (c) to mitigate the increased sensitivity on the Group's regulatory capital of change arising from Basel II; and
  (d) to accommodate the impact of the Treasury portfolio fair value adjustments.

Current trading

- Trading continues to be satisfactory and remains in line with the Group's expectations. "

"Dear Shareholder,

Proposed 2 for 5 Rights Issue at 275 pence per Share

- The Corporate division's strategy is asset class management, which is applied to establish selective asset growth while preserving strong margins and exercising vigilant credit risk management. To this end, the Corporate division continues to seek quality opportunities at the right price and with the right partners, concentrating on returns rather than volumes. "

31 July 2008 Interim Results.

"Lending growth however is being slowed." ***[Capital constraints were such that it had to be. The true position is grossly misrepresented.]***

- "During the first half of 2008, we have set in train a strategy of slower and highly selective growth, continuing to concentrate on markets where we have real expertise and can generate superior returns. Assets continue to be originated on the basis that we are comfortable to hold them on the balance sheet in their entirety, although a proportion of debt or equity positions may be sold down to other market participants if market conditions are supportive.

Prospects

- Our plans anticipate a worsening in the economic environment, resulting in higher impairment charges. "

APPENDIX III

EVIDENCE IN BOARD AND EXECUTIVE COMMITTEE MINUTES

In considering the following comments made in Minutes, cognisance should be taken of KPMG's role as Auditors and of the requirement for them to exercise professional scepticism when considering the risk aspects of the comments in relation to misstatement and non disclosure in financial statements. [KPMG would review Board Minutes as a matter of course in an audit.]

Group Management Board Meeting 20 January 2004

The Minutes demonstrate how focused the Management Board was on delivering results ahead of market median consensus and of reporting impairment provisions that were better than market expectations.

"to increase credibility and the market's likely view of the deliverability of the 20% ROE target" it was important that the first half results for 2004 were "increased by £50m to £80m, and to do this discretional items would be deferred".

Board Meeting 1 March 2005

It is evident from the Minutes that Retail division was under stress and was facing some major challenges, including a 20% fall in the UK mortgage market.

George Mitchell also commented that Corporate's growth target was challenging given the increasing levels of churn. He points out that performance was predicated in particular on key contacts, "the Group's extended family of entrepreneurs", and the integrated approach. He also points out the dependency on corporate finance deals (which are typically cash flow lends) and commercial property.

These are strong warning signs to the Board and additionally not one of them could be in any doubt regarding the risks attaching to the Corporate portfolio.

From a presentation to update the Board in relation to Basel II implementation, the rationale for Advanced Status is quite clearly nothing to do with strengthening risk management but is "the potentional for future reductions in regulatory capital and more imminently, the reputational and investor perceptions relative to competitors".

Executive Committee Meeting 17 May 2005

Basel II implementation was discussed at the Executive Committee Meeting on 17 May 2005. In February 2005 the programme had red flagged as a main consequence of Corporate division and concerns regarding the robustness of the internal credit risk models and their future deployment into business as usual. In addition "It was becoming increasingly clear that data quality was a potential stumbling block".

Those Minutes also confirmed the HBoS strategy to credit risk, which had been and was at that time, an approach "**focused on controlling absolute levels of loss**".

Executive Committee Away Days 5 and 6 June 2006

Andy Hornby summarised the Group's strategic weaknesses and the need for the Business Plan 2007 – 2011 to address the shortcomings, which included:

- Lack of sufficient credit risk capabilities;
- Over-reliance on wholesale funding;
- Lack of England and Wales SME share;
- Current Plan showing funding potentially becoming a constrain.

One of Andy Hornby's objectives of the planning process was to achieve double-digit growth in all years. In response Peter Cummings highlighted that in Corporate:

1. Significant further revenue growth would require a major shift in asset growth assumptions;
2. The portfolio had a 30% churn rate so that simply to stand still required c.£24bn of assets to be written each year;
3. As there was a very low share of the SME market then a step-change in performance **depended on being able to originate larger deals**;
4. In seeking to lead larger [syndicated] deals would have a material capital undertaking risk, unless or until the group's capital market capabilities were further advanced;
5. Post merger push in trying to increase market share "**had been focused excessively on quick wins, and had largely become focused on commercial property**";
6. To achieve the rate of growth Hornby was looking for required additional people capabilities in origination, where Corporate's strengths did not lie, and more risk would need to be taken in some asset-backed environments;
7. In particular, "**Any increased growth was likely to increase the group's exposure to commercial property.**";
8. A cyclical downturn in commercial property would necessitate a hold situation and work out over time.

Peter Cummings recommends high single digit growth to lessen the risks and particularly those relating to large scale lending against purely speculative property development deals. However a

major assumption to that recommendation and the deals that had already been struck was that there would be no material correction in the commercial property market.

With regard to International, a main target was increasing Corporate's market share in Europe. Traditionally this had been through leveraging international relationships linked to the North Sea Oil industry, which had been strongly asset backed. To move away from that was a high risk strategy.

The Minutes additionally include comment on excess levels of personal indebtedness in Retail and Corporate. Benny Higgins comments on Retail point to a floundering strategy and the need for a complete rethink. His initial address starts with a strong warning in relation to future impairments. Benny Higgins' summary of key Retail objectives, lacks any explanation as to how the objectives will be achieved, and is more a wish list that might deliver Andy Hornby's growth aspirations e.g. "SME was a key cross Divisional imperative". Of additional concern in Benny Higgins' comments is the linkage between unsecured personal loans and "looking hard at " PPI sales.

Executive Committee Away Days 31 October and 1 November 2006

Peter Hickman appears to alert the Executive Committee to potential irregularities in Reading and a requirement for large provisioning.

Additionally in an indirect reference to the Reading Incident, it is commented in relation to Corporate "the importance of limit management".

towards a conclusion that the Group should hold more property assets."

Board Meeting 22 May 2007

Significant sales issues in Retail were highlighted and in particular the ongoing shortfall in the mortgage business.

The Reading Incident was formally minuted as being a control weakness within Corporate division, which would lead to a significant provision during the year.

It was minuted that there were major challenges in relation to Corporate's Advanced IRB approach waiver application and in particular the General Corporate Models.

The Quarterly Key Credit Trends report showed that there were indications that the Corporate credit cycle was turning. A market correction had been expected for some time. It was commented that there it was difficult to track stress in the commercial property portfolio.

The minutes confirm that the strategy at that time was still to avoid distress and impairment ("primary focus on controlling absolute levels of loss").

Executive Committee Meeting 18 September 2007

Peter Hickman confirmed that the FSA had approved the AIRB approach credit risk waiver application. However there were significant conditions attaching to the waiver.

Executive Committee Away days 25 and 26 October 2007

In view of the continuing tightening of the money markets, the draft Funding Plan was discussed. Key assumptions were that securitisation markets would reopen in H1 2008 and that there would be sizeable capital and funding issuance in every non-holiday month. Stress testing of the base case for a re-run of similar conditions in September 2008, had shown "a very uncomfortable situation", which was survivable. However **"HBoS specific issues might prove to be difficult to cope with".**

Board Meeting 1 April 2008

Mike Ellis confirmed that economic belief was that there was no prospect of any material improvement in market conditions in the balance of the year.

Executive Committee Meeting 22 April 2008

This meeting was immediately prior to the AGM and the announcement of the Rights Issue on 29 April 2008.

The minutes include the following comment from Mike Ellis:

"The current forecast half year (2008) position with respect to Target Tier 1 Capital was unacceptable"

That comment is contradictory to the Interim Management Statement that was released on 29 April 2008 and which announced the Rights Issue.

Board Meeting 28 May 2008

Following Board approval of the FSA ARROW risk assessment and Risk Mitigation Plan, the outcome of the review was summarised.

"The Group was regarded as presenting a high systemic risk, because of its reach and relative importance".

Specific areas of concern included credit risk, capital, funding and liquidity.

Peter Hickman presented the Quarterly Key Credit Trends report and highlighted that there were signs of distress in the Retail and Corporate portfolios, and that the slowdown was having a clear impact on HBoS.

At this point, KPMG would have been involved in their review of the 5 months' results to 31 May 2008, which comprised the Trading Update released on 19 June 2008, and formed part of the Rights Issue Prospectus.

APPENDIX IV

CAPITAL REQUIREMENTS EXPLAINED

This is a very simple and high level walkthrough, but should be sufficient for the level of understanding that is required for the purposes of this report, and potential jury evidence.

Introduction

Basel is an international standard for the amount of capital that banks need to put aside to deal with current and potential financial and operational risks, or in other words the amount of capital that is required to absorb a reasonable level of losses before becoming insolvent. Banks are required to set aside more capital for higher risk exposures.

Applying minimum capital adequacy ratios serves to protect depositors and promote economic stability.

Risk based capital or regulatory capital is differentiated into two categories / standards, Tier 1 capital and Tier 2 capital, and is used by regulators to measure a bank's capital adequacy.

Tier 1 capital is the best form of capital and is capital which can absorb losses without a bank being required to cease trading e.g. ordinary share capital. Tier 2 capital provides a lesser degree of protection to depositors and is capital which can absorb losses in the event of insolvency.

Addressing the Criticisms

Basel I came into effect in 1988. A criticism of the regime was that it was too simple in application and that it was easy to achieve significant capital reduction with little or no risk transfer i.e. Basel I was, at a basic level, not sensitive to risk.

It had another fault. A material element of regulatory capital is what is called Core Tier 1 capital (the first cut of Tier 1 capital), which basically is a company's profit and loss reserves. Under Basel I, calculation of Core Tier 1 capital could be manipulated through restricting Specific Impairment Provisions, thus maximising profit and loss reserves and maximising regulatory capital.

As a result of the way that the minimum capital requirement was calculated under Basel I, HBoS through incentivising non-recognition of distress and in particular restricting the Specific Impairment provision, significantly improved their Tier 1 capital.

Basel II was introduced to address the criticism relating to risk aspects. The effective date in the UK for implementation was 1 January 2008 and as previously explained in 2004 all major banks in the

UK including HBoS commenced preparations for Basel II and the submission of waiver applications for Advanced approaches.

Basel II links capital requirements more tightly to the risks that banks incur. This was intended to have two motivational effects:

- Better risk management; and
- Safer, less risky credits (improved risk weightings).

It should be pointed out that until August 2008, the above benefits were not promoted in Corporate or even commented upon. What was strongly promoted by Peter Cummings prior to August 2008 was that it was a regulatory requirement, that Advanced Status was non-negotiable and that Corporate would need to be live to the cost of capital when doing deals. Within High Risk & Impaired Assets, this translated to churning High Risk connections back to the Good Book thus improving internal credit ratings.

There was a very high degree of scepticism. We had seen "credit" removed from the performance competencies of the front line during the Corporate journey. IAS Provisioning and distress status were overtly manipulated. Nexus was unreliable and subjective. It was patently clear that capital was going to be manipulated.

More of the Theory

Under Basel II, the capital requirements comprise two elements (Pillar 1 and Pillar 2), which are the regulatory capital requirements for credit, operational and market risks (Pillar 1) and any additional capital requirements identified through a bank's Internal Capital Adequacy Assessment Process (ICAAP), which are not captured under Pillar 1 e.g. to mitigate against concentration risk. The total minimum regulatory capital requirement is set by the FSA taking into account the ICAAP assessment. Basel II minimum regulatory capital requirements were designed to:

- Reduce risk of failure by cushioning against losses;
- Provide continuing access to financial markets to meet liquidity needs;
- Provide incentives for prudent risk management.

Basel II treated banks differently depending on the "sophistication" of their risk management systems.

Capital requirements are expressed as a percentage called the capital adequacy ratios and are Tier 1 and Tier 2 capital, plus combined, expressed as ratios of Risk Weighted Assets.

Under Basel I, Risk Weightings were determined by the regulator.

Under Base II Advanced approach for credit risk capital, the RWA are determined using banks' own internal credit ratings. Fundamental to all banks is or should be the management of credit risk. Credit risk was the most significant component of HBoS' Pillar 1 capital requirement. (Basel II Pillar 1

allowed banks to adopt different approaches / methodologies to determine their minimum regulatory capital requirements to support their exposures to credit, market and operational risks. There are three approaches, but for HBoS it was important to have approval for the adoption of the Advanced IRB approach.)

In theory under the Advanced IRB approach, Tier 1 capital could no longer be manipulated through avoidance of Specific Impairment Provisions. The HBoS Corporate response was to manipulate internal ratings / distress instead. RWA and Expected Loss calculations were thus understated meaning that the capital adequacy ratios were overstated.

HBoS and Basel II in more Detail

Work first began on preparing for Basel II in 2004. In Corporate division this required significant levels of investment in the development of credit risk rating tools, processes, governance and operations to support the Basel II Accord, and in particular the Advanced IRB approach. At no point was it explained within the High Risk & Impaired Assets arena as being from the point of view of improving credit risk management. **The concern and focus were entirely on the effect it would have on capital adequacy.** From a market reputation and perception perspective, it was not an option not to have the AIRB approach for credit risk regulatory capital in Corporate.

The AIRB approach is the most sophisticated approach. It allows banks to use their own internal assessment of probability of loss and default and the quantum of loss, to determine RWA values. To do this internal models are built to generate ratings (Probability of Default, Loss Given Default, Exposure at Default and Expected Loss) for products within the asset classes (loans). The Expected Loss is a combination of PD, LGD and EAD. The risk weightings that are derived are applied to credit risk exposures. The risk weighted asset itself reflects the Unexpected Loss in relation to the exposure.

Corporate division built an internal ratings model for credit risk called Nexus. Analysis of an obligor's financial statements together with qualitative assessment were then calibrated to the historic statistical data of default to give a Probability of Default rating. Similarly Loss Given Default was generated from historical statistical data of loss. The Expected Loss was thus heavily dependent on historic trending and data. If that historic data had been manipulated to underestimate default and contain loss, which HBoS had previously done, then Expected Loss will also be underestimated. Additionally for internal ratings to be reliable, they require "through the cycle" historic data, which Corporate did not have. Anything they did have was distorted due to non recognition of distress.

The AIRB approach for credit risk regulatory capital also changes the way in which the regulatory capital is calculated. Whereas under Basel I, Tier 1 capital could be influenced by manipulating the Specific Impairment charge (with the general [collective] charge being part of Tier 2 capital), under Basel II, it is the Expected Loss, which is important. The excess of Expected Loss less the accounting Impairment Provision is deducted 50:50 between Tier 1 capital and Tier 2 capital.

If the internal ratings improve, then RWA decrease and EL reduces, hence the capital adequacy ratios improve.

In terms of Corporate division this meant in addition to flawed historic data and subjective data input, there was another "simple fix" of reducing Past Due and High Risk exposures.

This desire ("instruction") wasn't hidden from anyone. Paul Burnett directly referred to discussions with Peter Cummings on the subject (at which it was probable that Hugh McMillan and others would be present).

To illustrate the point of how internal models can be manipulated to reduce capital requirements, a BIS study in 2013 required 15 banks to run their risk weighting models on an identical sample portfolio. The banks were spread and reported capital requirements varying from €3.4m to €34.1m for the same portfolio.

RESTRICTED STATEMENT: SALLY MASTERTON
INTERVIEW: 10 / 11 JULY 2013

2085B

LORD TURNBULL

OPERATION HORNET CRITICAL UPDATE

"Anything we can do to widen the gap will help the Audit Committee not to disclose, and that is something we seriously don't want to do especially at this moment". Peter Hickman, HBoS Group Risk Director; 11 February 2008

Strictly Confidential: Restricted to:
Sue Harris, Group Audit Director, Lloyds Banking Group

September 2013

HEALTH WARNING

This report has been prepared by Sally Masterton for the sole viewing at this time of Sue Harris, Group Audit Director, Lloyds Banking Group. It comprises the detail from an interview Special Investigator Mick Murphy of Thames Valley Police had with Sally Masterton on 10th and 11th July 2013, in relation to Thames Valley Police's ongoing Operation Hornet (HBoS) investigation under Detective Superintendent David Poole, Head of the Serious and Organised Crime Unit.

The extremely serious politically and commercially sensitive nature of the information and findings contained herein necessitate due caution and complete restriction within Lloyds Banking Group.

Thames Valley Police have a continuing interest but have not been provided with a copy of this report. The interview was conducted in the spirit of Project Windsor 2. The report contains information, which is material to their investigations.

Due Caution Explanation for Sue Harris

The former directors of HBoS and certain Senior Executives have committed serious breaches and violations of statutory and regulatory obligations, including those of a criminal nature.

Lloyds Banking Group has potentially serious conflicts to address.

LBG are implicated via Lloyds TSB.

There are questions to be asked of former directors of Lloyds TSB and LBG.

KPMG have breached statutory, regulatory and professional obligations and duties, including ones of a serious criminal nature. Their misconduct and failings are severe.

PwC have breached statutory, regulatory and professional obligations, including ones relating to money laundering offences. Their misconduct is of a serious nature.

An allegation has been made, which would suggest that the FSA may have had an involvement together with LBG, in concealing the misconduct and failings of KPMG.

The FSA are implicated in the 2008 Rights Issue.

In 2009 Deloitte may not have raised concerns, which should have been apparent, into the conduct of senior executives, the directors, KPMG, PwC and certain Insolvency Practitioners.

Other Insolvency Practitioners are implicated.

The market may have been manipulated on 24 July 2008; Morgan Stanley and Dresdner Kleinwort benefitted.

Questions need to be asked of Morgan Stanley in their role as joint sponsor of the November 2008 HBoS Placing and Open Offer.

In addition to the conflict and sensitivity that is apparent with regard to LBG's auditors, PwC and LBG's various relationships with KPMG, there are additional conflicts:

Andrew Whittaker, Group General Counsel is the former General Counsel to the FSA.

Morgan Stanley were joint sponsor of HBoS in 2008 (Michael Hartridge may be conflicted).

Freshfields Bruckhaus Deringer acted as legal advisers to Morgan Stanley in the Rights Issue and the November 2008 Placing and Open Offer.

The following senior LBG colleagues are implicated:

Philip Grant
Ian Goodchild
Steven Clark
Andrew Scott
Steve Gullon

There are other colleagues remaining in the business who have knowledge.

NON DISCLOSURE OF THE READING INCIDENT

Financial Statements 2002 to 2005

Annual Report & Accounts: year ended 31 December 2006

Interim Results and Trading Updates 2007

Annual Report & Accounts: year ended 31 December 2007

Interim Results and Trading Updates 2008

HBoS Rights Issue 2008

Acquisition of HBoS by Lloyds TSB

EXPLANATORY NOTES

This report does not provide individual case details pertaining to the Reading Incident. References to certain cases have been made for illustrative purposes and points of emphasis.

HBoS' role and the related roles of others in the Reading Incident are explained.

Operation Hornet is a large scale investigation. There are however a large number of other cases relating or pertaining to the Reading Incident, which are outside the parameters of Operation Hornet and which give rise to suspicion of criminality. Thames Valley Police are aware of a number of these related cases. However there has not to date been a full internal investigation within LBG to uncover the full extent of the Reading Incident and all criminality. LBG have only recently been made aware of the magnitude of the Reading Incident, accordingly a decision regarding further investigation (Project Windsor 2) remains to be made. Irrespective of that decision, Suspicious Activity Reports will be necessary and counsel should be sought in due course.

This report and its contents must be kept restricted and confidential. No separate Witness Statement has been made in relation to the interview by TVP on 10 and 11 July 2008. The report has been drafted in the spirit of Project Windsor 2 but has not been provided to TVP.

This report includes information relating to serious corporate criminality involving and stemming from the Reading Incident and is material to TVP's investigations.

All references to Regulation, Law, Accounting and Auditing Standards, Practice Guidance and so forth, is that which was applicable at the relevant times. The report uses terminology and titles in the context applicable to the relevant time period.

CONTENTS

INTRODUCTION

In November 2008 David Mills of Quayside Corporate Services Limited, who was later charged with money laundering and other offences, made the following comment to a journalist in relation to the losses incurred by HBoS as a result of the Reading Incident:

"that was because of Basel II coming in – that would penalise any bank with so many customers in high risk"

In one simple phrase, Mr Mills had got it right on a number of levels but for the wrong reasons.

What no one externally knew was the true "hornets' nest" of which the Reading Incident was a pivotal part.

Background

From the time of the wider uncovering within the Bank of the Reading Incident, which would appear to be during mid-2006, the Bank, its external auditors KPMG, Investigating Accountants and Insolvency Practitioners, have all portrayed the Reading Incident as having been perpetrated by one single "rogue banker", Lynden Scourfield as a result of a fundamental breakdown in controls. Those charged with governance, oversight and control, went without suspicion on the basis of no prior knowledge.

Even to a bystander with no knowledge of the systems of internal control and the financial reporting structures in place, the argument put forward lacked credibility.

Money Laundering

Suspicions of money laundering arose in early 2007 on the commencement of the first deep-dive internal inquiry. Despite regulatory and statutory reporting obligations, professional standards and ethics, and other duties, suspicions of money laundering were not reported then or at any point prior to Deloitte's s166 investigation.

Subsequent to the evidence that gave rise to those first suspicions, the known portfolio of Reading Incident cases have not been properly investigated to identify potential criminality and there has been no inquiry to identify further cases. Business relations continued with those who were potentially culpable of money laundering offences; in some instances further funds were advanced, significant fees were paid and in other instances, Insolvency Practitioners sold businesses and assets to those suspected of money laundering.

Non Disclosure

Of fundamental concern is that the Reading Incident, the extent of the losses / provisions, the potential criminality and how the Reading Incident was allowed to happen, were not disclosed to shareholders and potential investors.

In early 2009, the FSA instructed Deloitte under Section 166 of the Financial Services & Markets Act 2000 (FSMA) to carry out an investigation into the Reading Incident, the outcome of which was

Operation Hornet, a Serious and Organised Crime Unit investigation into potential money laundering offences.

Outwith money laundering offences there are other serious breaches, offences and misconduct that have not been duly reported.

In early July 2013, a puzzling series of spreadsheets relating to the Reading Incident and knowledge of documents which Project Windsor had previously Produced to TVP, linked into knowledge and experiences from 1998 to 2009. What had happened internally in relation to the Reading Incident finally made sense.

The Hornets' Nest

The Reading Incident raises very serious issues:

- Political
- Economic
- Criminal
- Civil
- Regulatory
- Reputational
- Professional

EXECUTIVE SUMMARY

Proper disclosure of the Reading Incident in July 2007 would have rewritten history for HBoS, Lloyds TSB and the Government.

The strategy since January 2007, and possibly from mid-2006, has been to conceal the Reading Incident.

Concealment set in motion a course of events that has had and continues to have far reaching and very serious consequences.

Substantial loss has been caused to HBoS ordinary shareholders (to July 2007), the subscribers to the HBoS 2008 Rights Issue (£332m) and to Lloyds TSB shareholders (£14bn) as a result of the actions of those involved. Compensation due to HBoS customers who were directly affected by the Reading Incident may be significant.

This report explains the rationale to the decisions made to conceal and those who are known or suspected to have been involved.

HBoS' high risk business strategy, non recognition of distress and avoidance of impairment, liquidity, Tier 1 capital adequacy, Basel II and non disclosure of the Reading Incident are all inextricably linked.

They were inextricably linked before the start of the financial crisis.

Deliberate non-disclosure of the Reading Incident in the 2007 financial statements fundamentally added to the crime and from that point on the deceit escalated as the financial crisis deepened.

The FSA was knowingly and recklessly misled.

However the FSA itself was reckless in influencing the Rights Issue without appropriate due diligence given their concerns from the 2007/8 ARROW risk assessment and having approved the Advanced IRB approach credit risk waiver (which reduced Retail risk weighted assets by £50bn) in the knowledge that Corporate's credit risk ratings were unreliable.

There was a significant deterioration in the Corporate Stressed Portfolio prior to the closing of the Rights issue in July 2008.

The Lloyds TSB Circular and Prospectus and the HBoS Prospectus in November 2008 knowingly do not disclose the true distressed cases in HBoS Corporate at that time, which at 30 November totalled £40bn.

Disclosure of the Reading Incident in the 2007 financial statements, would have given rise to going concern issues. Subsequent history is likely to have been radically different.

CULPABILITY FOR NON DISCLOSURE

Non disclosure of the Reading Incident was a paramount consideration pivotal to the Rights Issue. Irrespective of the Rights Issue, disclosure of the Reading Incident in the 2007 Annual Report would have had very serious implications for HBoS and raised going concern issues.

Disclosure to the FSA during 2007 of the magnitude of the Reading Incident as extending into all Corporate distressed and Good Book connections, its true causality, the non recognition of distress and impairment in Corporate, overstatement of regulatory capital, and the serious implications all of these presented in terms of HBoS' risk management framework would have severely impacted, if not halted progress in attaining Advanced Status under the Basel II framework. This would in turn have had significant ramifications in terms of regulatory capital requirements. Advanced Status IRB approach for Retail was a key priority.

Disclosure of the Reading Incident to the market in July 2007 and reporting of suspected money laundering would have had a substantial impact on the HBoS share price, deposits and external credit ratings.

Those culpable include:

- **Andy Hornby (CEO)**
- **Sir Dennis Stevenson (Chairman)**
- **James Crosby (Former CEO)**
- **Peter Cummings (Corporate CEO)**
- **Sir Ron Garrick, Chairman of divisional Corporate Risk Control Committee**
- **Mike Ellis (Group FD)**
- **Audit Committee**
- **Other HBoS Board members**
- **KPMG (Auditors and Reporting Accountants)**
- **Peter Hickman (Group Risk Director)**
- **Stewart Livingston (Chief Risk Officer)**
- **Ian Goodchild (Head of Group Risk – Credit)**
- **Steven Clark (Group Risk – Credit, Commercial)**
- **Andrew Scott (Lead Director, London High Risk)**
- **Tom Angus (Head of Impaired Assets)**

Those who are additionally complicit in relation to the non disclosure but otherwise culpable include:

- **Hugh McMillan (MD Risk, Corporate)**
- **Paul Burnett** (Paul Burnett's culpability may extend further)
- **Corporate Credit Risk Committee**
- **Other members, Group Credit Risk**
- **Internal Audit**
- **PwC**

THE RISKS FOR LLOYDS BANKING GROUP

Evidence

LBG is already exposed to significant reputational risk and risk of litigation as a consequence of the documents that Project Windsor previously Produced to Thames Valley Police as evidence for Operation Hornet. Thames Valley Police has also undertaken due enquiry.

Operation Hornet is a criminal investigation and the evidence will be heard in Court. It will be a very public affair. The FCA has a strong interest in the case and has continuing liaison with Thames Valley Police. There is already strong media interest, which Thames Valley Police are containing. The Operation Hornet case will not be a conclusion in itself. The Reading Incident is large and complicated. A number of significant individual cases are outwith the parameters of Operation Hornet. However in investigating the Hornet case, Thames Valley Police have considerable evidence relating to potential criminality in the other cases, which will be referred to the Serious Fraud Office together with untried Hornet cases. It is highly probable that a new inquiry will be opened and the "Lord Turnbull" evidence will pass across.

The documents previously produced by Project Windsor specifically reveal that the Reading Incident was deliberately concealed when it should have been disclosed in the 2007 Annual Report and Accounts, the June 2008 Prospectus relating to the Rights Issue and the November 2008 Circular and Prospectuses relating to the Scheme of Arrangement, Placing and Open Offer regarding the acquisition by Lloyds TSB.

Consequences

There have been serious breaches of regulatory and statutory duties, and other reporting obligations. Certain of the breaches constitute criminal offences.

The implications are far reaching and extend to the roles of the FSA, KPMG, PwC and other accountancy firms.

Substantial loss has been caused to HBoS ordinary shareholders (to July 2007), the subscribers to the HBoS 2008 Rights Issue (£332m) and to Lloyds TSB shareholders (£14bn). Compensation due to HBoS customers who were directly affected by the Reading Incident may be significant.

The HBoS share price was c.£10 in August 2006, £10-£11 in February and March 2007, 940p on 2 August 2007 and 634p on 28 February 2008.

LBG Related Issues

There is evidence to suggest that Lloyds TSB may have been aware of the potential money laundering at the time the Circular and Prospectus for the acquisition of HBoS were being prepared.

Lloyds TSB (former Large Corporate, Bristol) are a party to significant suspicious transactions relating to potential money laundering offences. The former Head of Large Corporate based in Bristol and

the Relationship Manager both remain in the Bank. There is a possibility that proceeds of crime may extend to relationships originating in Lloyds TSB including The Parkmead Group plc.

An allegation has been made, which would suggest that the FSA may have had an involvement together with LBG, in concealing the misconduct and failings of KPMG.

A number of former senior executives and directors of HBoS are involved. The involvement of two senior directors both of whom remain in the Bank, including the former Head of Group Risk-Credit, is evidenced in the documents Project Windsor Produced to Thames Valley Police. The involvement of Stewart Livingston, the former Chief Risk Officer, Corporate is also evidenced but he has recently left LBG. The former Chief Operating Officer of HBoS Corporate Division remains within LBG at a senior level.

DOCUMENTATION PRODUCED BY PROJECT WINDSOR TO TVP

Background

Peter Hickman was aware that Impairment in relation to the Reading Incident was an Exceptional Item and material in relation to the financial statements for year ended 31 December 2007.

There were similar considerations in relation to the Corporate Governance Statement and the "comply or explain" requirement in relation to the fundamental breakdown in Corporate's internal controls, the full background to the breakdown and the actual and potential impact on Corporate. In such situations, the directors are also required to give explicit confirmation that necessary actions have been taken to remedy any significant failings or weaknesses in internal controls.

Tom Angus was ultimately tasked with compiling a schedule for the Audit Committee on which they could make an assessment whether or not to disclose the Reading Incident in the financial statements and Corporate Governance Statement. Peter Hickman wanted to argue a case for non disclosure based on audit materiality.

Peter Hickman (Group Risk Director), acted as liaison between the Audit Committee and Executive Committee, Ian Goodchild (Head of Group Credit Risk), Steven Clark (Head of Group Credit Risk; Corporate), Stewart Livingston (Corporate Chief Risk Officer) and Tom Angus.

Concealment

The project was initially "sold" to Tom Angus by Peter Hickman via Ian Goodchild and Stewart Livingston as being part of an exercise to convey the higher level lessons learned from the Reading Incident and was required by the FSA. Tom was instructed to compile a schedule showing the Reading Incident Impairment Provisions.

The documentary evidence shows that the schedule Tom ultimately submitted had been contrived to show a total Provision figure that was below an arbitrary measure of materiality of 5% of net income from Group continuing operations. As explained within the detail of the report, the premise for that arbitrary measure was in any event inappropriate to the circumstances.

Tom Angus has confirmed that the schedules contained on the shared drive were compiled in contemplation of the Rights Issue and were compiled within certain artificial "criteria", which markedly reduced the total exceptional amount to within £285m.

One of the "criteria" was to restrict cases to those having the involvement of Lynden Scourfield and then, not those that migrated into the Stressed Portfolio after Lynden Scourfield had effectively left the Bank in January 2007.

Emails

The 5% arbitrary absolute based on £5,708m was £285m. (Underlying Profit before Tax for Corporate was £2,320m.) There are various drafts of the schedule, which were shared with Stewart Livingston, Steven Clark, Ian Goodchild and Peter Hickman. In one exchange of Emails Peter

Hickman makes the comment to Stewart Livingston: "We are getting uncomfortably close at £265m. £285m is not a hard limit. Anything we can do to widen this gap will help the Audit Committee not to disclose, and that is something we seriously don't want to do especially at this moment". In another exchange, Peter Hickman raises with Ian Goodchild the issue of reporting the fraud.

The actual Impairment Loss incurred with respect to what has been identified to date as Reading Incident cases is **in excess of £1bn**. An Email from a manager working with Tom in compiling the schedule, queries the accuracy and legitimacy of the schedule, on the basis that it significantly misstated the total Reading Incident Provisions raised to that date (31 December 2007), which the manager says are **c.£800m**.

The schedule Tom was compiling was significantly and knowingly erroneous.

On 11 February 2008 Steven Clark sent an Email to Ian Goodchild attaching another draft of Tom's schedule. That schedule totalled £266m and comment is made that £22m of 2008 Provisions, which had been raised post year end, had been removed from the £266m. It is patently evident from the schedule that even in relation to the connections on the schedule, significant further Provisions would be required. Steven knows the schedule is wrong and in what seems to be an attempt to force proper disclosure makes reference to the Turnbull Guidance.

Ian Goodchild then sent an Email to Peter Hickman copied in to Tim Thompson (new Head of Group Credit Risk) and Stuart Dickson. Ian points out about the additional but excluded £22m. He further asks Stuart to provide an estimate of the amount of loss that would have been incurred in any event if the "fraud" had not been committed. He does not point out about the £500m+ that had been excluded!

The schedule submitted on 14 February 2008 totals £262.4m. The schedule is very clearly incorrect.

[Note: Although knowingly wrong: 262.4 + 22 =284.4]

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LLOYDS BANKING GROUP

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020 7356 2383 direct
sue.e.harris@lloydsbanking.com

7 October 2013

FCA
25 The North Colonnade
Canary Wharf
London
E14 5HS
For the Attention of: Alison Carpenter, Acting Head of Department, Large Retail Banking Groups 1

PRA
20 Moorgate
London
EC2R 6DA

For the attention on: Jean Moorhouse, Manager, Lloyds Banking Group Supervision Team

Dear Alison and Jean,

Allegations made by Sally and Colin Masterton

I refer to our email dated 7 October 2013 enclosing the report of our investigation into Mr and Mrs Masterton's allegations. As you may recall, we originally notified you that Mr and Mrs Masterton made a number of extremely serious and wide-ranging allegations which included: (i) allegations of harassment against a number of LBG employees; (ii) concerns, as a consequence of the harassment allegations, as to the way in which the internal team (known as Project Windsor) responding to the various regulatory and criminal investigations was governed; and (iii) allegations of wider irregularities in the context of the HBoS Reading office. When we initiated the investigation, we informed you[1] that our investigation would focus in the first instance on the harassment allegations and that we would consider how to engage with the other issues raised in the light of that investigation.

The harassment allegations were the subject of a thorough investigation involving significant management time and the oversight of our external legal advisers, Freshfields Bruckhaus Deringer. No evidence was found to support the allegations, which were at odds both with the evidence of all the other employees interviewed (whose evidence, to the extent it overlapped, was consistent) and with the contemporaneous documents.

As set out in the report of the investigation provided to you we concluded, not only that their allegations were unsubstantiated, but that members of the Project Windsor team had acted properly and professionally throughout in their dealings with Mrs Masterton. Accordingly, there was no basis to review the allegations they had raised in relation to the way in which the Project Windsor team was governed.

[1] Telephone call on 12th June 2013 between Rupert McNeil and Andrew Whittaker and Julia Dunn FCA, and on 19th June 2013 with Jean Moorhouse PRA.

In September, LBG received the enclosed document from Mrs Masterton which sets out further – very serious and wide-ranging – unparticularised allegations against LBG/HBoS and a number of other organisations, including the FSA. The only part of the document which makes an attempt to refer to supporting evidence is at pages 13-14. It is clear from the headings and context of the document that certain of the matters referred to in it are relevant to an ongoing investigation being conducted by Thames Valley Police (TVP) and that the information contained in it, including the documents referred to at pages 13-14, have already been made available to them. Many of the individuals named have also been interviewed by TVP as part of their investigation. Whilst LBG is not aware of the precise scope of TVP's investigation, it would clearly not be appropriate for us to commence a fresh investigation of our own into matters which TVP are already reviewing.

We note that many of the matters raised in the document have been previously – or are currently – the subject of reviews and/or of investigations by other regulators, including FCA and FRC. Given this and the ongoing police investigation, LBG is not persuaded, in the light of the outcome of the harassment investigation, that it would be appropriate to conduct another wide-ranging investigation based on allegations made by Mrs Masterton.

We do not propose to do anything further in relation to the allegations raised in this latest paper at this time. We of course will keep the matter under review and reassess the position if any new information emerges, and will keep you appropriately informed.

If you would like to discuss please do let me know.

Yours faithfully

Sue Harris
Group Audit Director

cc. Rupert McNeil – Group HR Director
Andrew Whittaker – Chief Legal Counsel

Sycamore Limited

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M J Boston,
Company Secretary,
Lloyds Banking Group,
25, Gresham Street,
London EC2V 7HN

RECORDED DELIVERY

Our ref: 140331 Your ref: 31 March 2014

Corporate Jet Realisations Limited ("CJR")

Dear Sir

We refer to a letter dated 27th March sent by email from your solicitors with copies to Dr Vince Cable and to Andrew Tyrie, in response to our letters to you of the 18th and 21st.

Your solicitors state that you have "notified the appropriate senior members within the Bank of (Sycamore's) recent correspondence". This is not the confirmation we asked you for. It is both equivocal and objectively meaningless; and no doubt deliberately so. We require a simple "Yes" or "No" answer: have you, Mr Boston, copied to the full board of Lloyds Banking Group the correspondence, including this letter, which we have exchanged with you concerning our offer to acquire the LBG claim in the liquidation of CJR?

We require your answer by 7th April.

The then HBOS board in 2002 set up and funded CJR to avoid taking a bad debt on its lending to Chauffair Limited. Between then and September 2007 it progressively lent an estimated £150 million to and through CJR a company which never made a profit, had no substance and failed to prepare or file accounts in blatant and repeated criminal breach of Company Law, which alone should have required the Bank to close it down. The loans were of a level which required main board approval.

HBOS directors induced Corporate Aircraft Leasing Limited ("CALL"), our group's then JV with HBOS, to lease an aircraft to CJR. HBOS put CJR into Administrative Receivership on 26 September 2007 in the hands of Messrs Chubb and Jervis, insolvency practitioners with PricewaterhouseCoopers, who immediately sold the company for a nominal sum to its existing directors and management with no attempt to find an outside buyer. HBOS made some recoveries by the sale of aircraft but, that apart, the lending was written off. HBOS caused CALL substantial loss by paying off all trade creditors of CJR other than CALL in spite of repeated assurances by officers of HBOS that CALL would not suffer loss.

LBG, Mr Chubb and Mr Jervis refuse to supply to the Liquidator of CJR information to which he is legally entitled to aid him in making recoveries and fulfilling his statutory duties.

Nonetheless the Liquidator and Sycamore will continue to pursue those recoveries through all available channels.

HBOS attributed the losses to "overenthusiastic lending" by a junior manager at its Reading unit and made no attempt to pursue recovery from any party. This position has been maintained by the Lloyds board since the merger. That junior manager and some of his associates in CJR both within and outside the Bank are currently being prosecuted for fraud and money laundering in relation to the Reading unit, but, we note, not in respect of CJR.

You have refused to sell to Sycamore Ltd the LBG claim in the liquidation of CJR so that it can (i) in conjunction with its own claim, seek from the individuals responsible the recoveries you have failed to seek; and (ii) make a substantial donation to Help for Heroes. While British servicemen and women were suffering life changing injuries in Iraq and Afghanistan those responsible for CJR were, as you well know, enjoying and continue to enjoy huge bonuses, private aircraft travel, a luxury yacht in the Mediterranean and a millionaire lifestyle, all at the cost of your shareholders. You now still refuse to help the heroes even at no cost to you, your board or your shareholders.

You decline to advance any justification or reason for that refusal. Your solicitors say that you "do not intend to debate your reasons" for that "commercial decision". While you and your solicitors have no doubt debated them, we at least cannot debate your reasons because you have given us none. CJR was never a bona fide commercial enterprise and we do not accept that your secret reasons are bona fide commercial reasons.

We urge your new board to reconsider its apparent support for those responsible for CJR and to meet us to progress our offer.

We are copying this letter to Dr Vince Cable, to Mr Andrew Tyrie, to Mr Thomas Minogue and to the Financial Conduct Authority.

Yours faithfully,
SYCAMORE LIMITED

M L PAGE
Director
mpage@sycamore.aero

cc Dr. Vince Cable. Secretary of State
Andrew Tyrie MP
Martin Wheatley, the FCA (*with HSF incoming)*
Mr Thomas Minogue (*with HSF incoming)*

Andrew Whittaker
Group General Counsel

LLOYDS BANKING GROUP

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E14 5HS

For the attention of Debbie Perkins

8 May 2014

Dear Debbie,

Allegations made by Sally Masterton

We refer to our letter dated 7 October 2013 enclosing a document that we received from Mrs Masterton in early September 2013 headed "Lord Turnbull: Operation Hornet Critical Update" (***the Critical Update Document***), which set out a series of – very serious and wide-ranging – unparticularised allegations against LBG/HBOS and a number of other organisations, including FCA.

LBG received the enclosed 158 page document from Mrs Masterton, headed "Project Lord Turnbull – Operation Hornet" (***the Report***) earlier this year. The Report is marked "draft" and we understand that the Critical Update Document previously provided was an "initial first draft front section" of the Report. The Report sets out further – again, very serious and wide-ranging – unparticularised allegations against LBG, HBOS and a number of other organisations, including FCA. Although the Report is significantly longer than the Critical Update Document, there continue to be very few references in the document to any evidence in support of the allegations contained within it.

We, and our external legal advisers, have reviewed the Report and are considering whether any aspect of it requires further investigation by LBG. We think this is unlikely for the reasons we have stated previously.

It is clear, including from the headings and context of the document, that a number of matters referred to in it relate to an ongoing investigation being conducted by Thames Valley Police ("TVP") in the context of Operation Hornet and information relating to those matters has already been made available to TVP. As with the Critical Update Document, many of the individuals named have also been interviewed by TVP as part of Operation Hornet. Whilst LBG is not aware of the precise scope of TVP's investigation, it remains our view at this stage that it would not be appropriate for LBG to commence a fresh investigation of our own into those matters which TVP are already reviewing.

We have not yet identified any matters in the Report which persuade us, in the light of the outcome of the previous investigation and its evaluation of the credibility of Mrs. Masterton, that it would be an appropriate use of time and money to conduct another wide-ranging investigation based on allegations made by her, particularly given that many of the matters raised in both the Critical Update Document and the Report have been previously – or are currently – the subject of internal reviews and/or of investigations by other regulators, including FCA (in particular, Project Windsor, relating to LBG's observance of its Principle 11 obligations in the context of HBoS Reading) and FRC.

At this stage, we do not propose to do anything further in relation to the allegations raised in it, save to continue to assist TVP with their ongoing investigations. As advised previously, we will keep the matter under review and reassess the position if any new information emerges, and will keep you appropriately informed.

Please let us know if you disagree with this approach or have any particular concerns relating to the enclosed report.

Yours sincerely,

Andrew Whittaker
Group General Counsel
Lloyds Banking Group