PART A: Response to LBG's request for clarification of Recommendations made in the Cranston Report

1. My second report is concerned with giving effect to the recommendations I made in the Cranston Report for the establishment of the process for reassessment of customers' direct and consequential loss claims: the Panel.

2. I made other recommendations in the Cranston Report, which were for the Bank to implement. The Bank has undertaken a good deal of work to implement Recommendation 1 (de facto directors) and Recommendation 2 (debt relief), in particular. However, in the course of that work, some issues have arisen as to the interpretation of relevant sections of the Cranston Report.

3. The Bank have asked me to clarify these aspects of my recommendations and I have agreed to do so. The Bank has posed a total of nine questions for me (two in relation to de facto directors and seven in relation to debt relief).

4. I have considered these questions using the same inquisitorial approach that I adopted for the Cranston Review and indeed for the work which led to my second report. I have been assisted by the same Counsel (Rory Phillips QC and Kate Holderness) and, in relation to debt relief, by Simon Kirkhope of FTI Consulting LLP (FTI), who led the FTI team which assisted me on the Cranston Report.

5. The answers which I set out below are general answers to the general questions of interpretation which have been put to me. In them, I explain what I meant in the Cranston Report. I am not seeking to determine the right answer in any particular case, nor am I making a decision on the facts of any customer's case.

6. It will be for the Bank to apply the answers which I have given in its work to implement Recommendations 1 and 2. In Part B of this document, I will outline briefly the process which will then follow and the "appeals" process which I recommend that the Bank puts in place for customers who are not happy with the decisions which it makes.

De Facto Directors

7. Recommendation 1 of the Cranston Report provided:

> "Recommendation 1.1: The Bank must reconsider all cases where an individual sought inclusion in the Customer Review on the basis that they were a de facto director or were otherwise involved in the running of the business.
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> Recommendation 1.2: In determining whether an individual was a de facto director or actively involved in the running of the business, the Bank should take into account all relevant evidence, and give weight to the individual's written statement and any corroborative statements of others involved in the running of the business at the relevant time.
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> Recommendation 1.3: Where an individual who is found to qualify for inclusion in the Customer Review in this way is a spouse or partner of another director of the business, in the absence of evidence to the contrary, the Bank should consider each of them to have suffered the same or similar distress."

(1) Relevant time: what is the "relevant time" for the purposes of determining whether an individual was a de facto director or actively involved in the running of the business?

8. The Bank proposes that the "relevant time" for the purposes of Recommendation 1.2 should be the time at which the relevant individual's business entered IAR. They have explained to me that their reason for choosing this time is to ensure consistency of treatment with customers who were deemed eligible to participate in the Customer Review.

9. As I explain in paragraphs 3.35 and 3.39 of the Cranston Report, the Bank decided that all directors in office at the time a business was first referred into IAR would be eligible to participate in the Customer Review. It excluded directors who resigned before the business' entry into IAR and directors who started in office after its entry into IAR.

10. Its methodology on de facto directors simply set out the circumstances in which an individual who was not appointed a director, but acted as such, would be treated as a director for the purposes of establishing eligibility. Therefore, the same timing constraints applied to both de jure and de facto directors for the purposes of establishing their eligibility.

11. However, as I explain in paragraph 11.30 of the report, in the case of de jure directors who were appointed after a business' entry into IAR, the Bank considered on a case-by-case basis whether to admit those directors into the Customer Review.

12. Therefore, I do not agree with the Bank's interpretation of Recommendation 1.2. I expect the Bank to take the same approach to de facto directors and others involved in

the running of a business who assumed their roles after the relevant business' entry into IAR as it took in relation to de jure directors. In each case, it must consider whether the customer claiming to be a de facto director, or someone involved in running a business, interacted with the fraudsters and/or suffered detriment as a result of the introduction of QCS. This is necessary to ensure consistency of treatment with customers who were deemed eligible to participate in the Customer Review.

(2) Active involvement: how should the phrase "actively involved in the running of the business" be interpreted?

13. The Bank proposes that this phrase should be interpreted as "actively making decisions equivalent to those that would have been made by a formally appointed director, and with sufficient autonomy to do so without reference to such a director".

14. As I explain in paragraphs 3.41 to 3.42 of the Cranston Report, the Bank's methodology on de facto directors required evidence that an individual was consistently referred to or treated as a director, or evidence that an individual was involved in the running of the business such that they were effectively discharging the role of a director.

15. In paragraphs 11.21 to 11.24 of the report, I criticised the Bank's approach to de facto directors. My criticisms focused on the undue weight placed by the Bank on how HBOS regarded the relevant individuals at the time, and its failure to give sufficient weight to the relevant individuals' submissions. Then at paragraphs 11.86 and 11.87 the report states:

> "However, I consider a deficiency in the definition of the Customer Review population that, with individuals, the focus was on directors... That was a sensible starting point, but it should not have been the end of the inquiry. After all, the Bank's stated intention was to compensate those affected by the IAR fraud... the methodology to identify impacted customers involved in running a business did not apply in these respects to produce fair and reasonable results."

16. At paragraphs 15.31 to 15.38, I reiterated the criticism made at paragraphs 11.21-11.24 but also set out how the Bank should go about implementing Recommendation 1: (i) the Bank must consider who may have been affected or impacted by the fraud (as it had stated its intention in the press release); (ii) importantly, this was not simply a matter of applying a legal test; and (iii) in the absence of evidence to the contrary, a spouse or

domestic partner should be considered to have suffered the same or similar as the customer in the Customer Review.

17. Accordingly, the Bank must adopt a broader interpretation of the phrase "actively involved in the running of the business" than it proposes. It must ask itself whether, as a matter of fact, whatever a person's position in the business, and whatever the formal position as regards decision-making, they were actively involved in running the business. Ultimately important decisions might have required formal approval by the directors. However, running the business on a day to day basis – and having to bear the brunt of dealing with the criminal bankers and/or their co-conspirators – might have been someone who would not meet the legal test of being a de facto director. Only if the Bank adopts a broad approach will it deliver its stated aim of compensating those affected or impacted by the fraud.

18. Moreover, when determining whether an individual was actively involved in the running of a business, the Bank must give due weight to the relevant individual's submissions, in accordance with Recommendation 1.2.

Debt Relief

19. Recommendation 2 of the Cranston Report provided:

> "In line with this approach, the Bank must reconsider customers' eligibility for debt relief payments where such debt existed at the time of the IAR fraud, and that debt was subsequently repaid or refinanced before the commencement of the Customer Review."

20. The reference to "this approach" is a reference to the approach set out in paragraphs 15.40 to 15.47 of my report. The key paragraphs are 15.40 to 15.42, which provided:

> "15.40. Against that background I have concluded that the Bank should revisit this policy in line with the recommendations below, which are to be implemented retrospectively.
>
> 15.41. The Bank's policy on debt write-off should be amended on the following basis:
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> (1) Any customer who had a non-nil outcome and had outstanding indebtedness (of the type set out in sub-paragraph 2) at the relevant time (described below in subparagraph 3) is eligible for debt write off.

(2) The type of indebtedness covered should be consistent with that to which the Bank applied its policy during the Customer Review, i.e. mortgage debts, personal loans, business debts (in the customer's personal name), or outstanding personal guarantees for business debts.

(3) The relevant time for determining eligibility is the date at which the Bank's debt was either repaid, refinanced with another institution, or was demanded (by court enforcement process or otherwise), provided that such debt existed at the time of either (i) the business' exit from IAR; or (ii) the failure of the business.

15.42. Eligible customers should be compensated on the following basis:

(1) Where debt has been repaid, customers should be compensated for the debt outstanding at the time the repayment was made to the Bank, together with compensatory interest at 8% from that date;

(2) Where debt has been refinanced with another institution, customers should be compensated for the remaining debt outstanding (with that institution or any successor, in the case of multiple refinancings) at the commencement of the Customer Review, together with compensatory interest at 8% from the date that they received their final outcome letter; and

(3) Where debt was demanded or enforced (but neither repaid by the customer nor refinanced), customers should be compensated for the debt outstanding at the time the demand was executed or the enforcement process completed, together with compensatory interest at 8% from that date."

(1) Corporate debts: was corporate debt intended to be included in the debt relief definition set out in 15.41(2)?

21. The Bank has asked me to clarify whether paragraph 15.41(2) extends to corporate debts, or is limited to personal debts.

22. The background to this recommendation is set out at paragraphs 10.60 to 10.67 of the report. In the Customer Review, the Bank wrote off the debts of 18 customers, amounting to more than £6.3million (paragraph 10.61). This was not provided for in its methodology, although there was a passing reference to it there (see paragraph 12.27 of the Cranston Report). The Bank did so (as it put it) "to provide additional help" to those impacted by the fraud. In a press release dated 7 April 2017, the Bank stated that it would:

> "[w]rite off customers' remaining relevant business and personal debts currently owed to [the Bank], where they were victims of the criminal conduct, and not pursue them for any repayment."

23. The purpose of Recommendation 2 was to ensure that customers who had refinanced their debts with other lenders, or who had repaid their debts to the Bank by liquidating assets or by some other means, were not discriminated against.

24. The recommendation was intended to ensure that such customers were offered the same relief as customers who owed debts to the Bank at the time of the Customer Review, i.e. the intention was to ensure consistency (or equality) of treatment of all customers.

25. It is important to emphasise that I was concerned about the impact of the Bank's policy on debt relief on individuals, and not its impact on the businesses with which they were associated. I was seeking to ensure consistency of treatment of the individual customers.

26. According to the information provided by the Bank during the Assurance Review, in all but one case the Bank wrote off only personal debts and business debts in the customer's personal name.

27. In the case of one business (with whom four customers were associated), the Bank wrote off both the corporate debts and the personal debts of the director shareholders. These customers and their debts were included in the figures quoted in paragraph 10.61 of the report. The personal debts included personal guarantees for the business' debts, and it was in writing off those personal debts that the Bank benefited the director shareholders. I understand that they did not obtain a direct personal financial benefit from the writing off of the corporate debts (over and above the release of their personal guarantees).

28. Paragraph 15.41(2) was deliberately confined to personal debts and business debts in the customer's personal name. Although the Bank did write off the corporate debts of one business in the Customer Review, in my view this does not justify the extension of Recommendation 2 to all corporate debts. As I have explained above, in that particular case the writing off of the corporate debts did not benefit the individual customers. Recommendation 2 was concerned with the impact of the Bank's debt relief policy on individual customers.

29. However, I am not ruling out the possibility of customers receiving compensation for corporate debts which were outstanding at the time the relevant businesses exited IAR. The key finding of the Cranston Report was that the Customer Review made no awards

for direct and consequential loss and that a Panel should be constituted to assess such loss. In the event that the Panel finds that a corporate debt constitutes direct and consequential loss, it will no doubt award appropriate compensation accordingly.

(2) Sole Trader and Partnership debts: Are the debts of sole traders and/or partnerships to be considered as personal debts?

30. The Bank has asked me to clarify whether debts incurred by sole traders or partnerships constitute "business debt (in the customer's personal name)".

31. The Bank seeks to draw a distinction between business debts and personal debts in line with commonly held principles and practices in banking:

    a. Business debt – lending to businesses for business purposes, i.e. commercial enterprises operating with a purpose of making a profit / return.

    b. Personal debt – lending to individuals for personal uses, such as purchase of a home or other assets for personal use.

32. The Bank acknowledges that personal debts may be incurred in order to cover personal liabilities to a business, and suggests that this is what is meant by "business debt (in the customer's personal name)". However, it considers that debts incurred by sole traders or partnerships are in a different category, as they are made and remain for the purpose of business.

33. In my view, the Bank's interpretation of the phrase "business debt (in the customer's personal name)" is inaccurate. Recommendation 2 was intended to encompass all debts for which an individual (i.e. not a limited company or limited liability partnership) was liable. Sole traders and partners have personal liability for business debts. As I have explained above, the purpose of Recommendation 2 was to ensure that all individuals impacted by the fraud benefitted from the Bank's policy on debt relief. That purpose would be frustrated if individuals who operated as sole traders or in partnership were left with debt for which they were personally liable.

(3) Nil outcomes: should all customers who participated in the Customer Review be eligible for debt relief, including those that received a nil outcome?

34. The Bank has interpreted paragraph 15.41(1) as excluding from Recommendation 2 those customers who received a nil outcome in the Customer Review, on the ground that customers who received a nil outcome "were determined not to have been impacted by the actions of the criminals and are therefore not eligible for debt relief".

35. In my view, the Bank's interpretation is correct. The intention of Recommendation 2 was to benefit only those customers who were impacted by the fraud. Customers who received a nil outcome in the Customer Review were found not to have been impacted by the fraud.

36. In the event that the Panel concludes that a particular customer ought not to have received a nil outcome in the Customer Review, I would expect the Bank to give that customer the benefit of Recommendation 2.

(4) Relevant time: If a debt existed at the commencement of the Customer Review, that was originally HBOS personal debt, and was refinanced prior to the company exiting IAR or failing, is it eligible for debt relief?

37. The Bank wishes to know whether a customer's debt with it is eligible for debt relief if it was repaid, refinanced with another institution or demanded prior to the time of either (i) the business's exit from IAR; or (ii) the failure of the business.

38. The Bank's interpretation of paragraph 15.41(3) of the Cranston Report is that "such debt" (in the phrase "provided that such debt existed at the time of either (i) the business' exit from IAR; or (ii) the failure of the business") refers to the customer's debt with the Bank i.e. the debt originally borrowed from and owed to HBOS or one of its subsidiary entities.

39. The intention behind paragraph 15.41(3) was that debt relief should not apply to debts that were repaid prior to exit from IAR or failure of the business. However, it was not intended to exclude customer's personal debts which were re-financed with another lender and still existed at the time the customer's business exited from IAR or failed. To the extent that any of that refinanced debt was outstanding at the date of the

commencement of the Customer Review (as required by 15.42(2)), that debt should be eligible for debt relief.

(5) LBG Group companies: Which Group entities are being referred to as the 'Bank's' debt?

40. The Bank's view is that Recommendation 2 should be limited to debt originally borrowed from and owed to HBOS or one of its subsidiary entities, and should not extend to debts borrowed from other entities that became part of the wider Lloyds Banking Group after the 2009 acquisition of HBOS by Lloyds TSB.

41. However, the Bank has informed me that in the Customer Review it did not limit its debt write off policy to debts originally borrowed from or owed to HBOS or one of its subsidiary entities.

42. As I have said above, Recommendation 2 was intended to ensure that customers who had refinanced their debts with other lenders, or who had repaid their debts to the Bank by liquidating assets or by some other means, were offered the same relief as customers who owed debts to the Bank at the time of the Customer Review, i.e. the intention was to ensure consistency (or equality) of treatment of all customers.

43. Therefore, in my view Recommendation 2 should extend to debts originally borrowed from and owed to any entities within the Lloyds Banking Group.

(6) Revisiting the policy of writing off customers' debts: Should the Bank be revisiting the debts that it wrote off during the Customer Review?

44. The Bank has explained to me that it understood Recommendation 2 as not requiring the Bank to revisit the application of its debt relief policy to customers whose debts were written off at the time of the Customer Review.

45. The Bank's understanding is correct. The intention when making the debt relief recommendation was to ensure that customers who had not been offered debt relief (e.g. because they had repaid or refinanced their Bank debts) should receive equivalent treatment to those who had been offered debt relief in the Customer Review. It was not to require the Bank to take steps to revisit its treatment of customers who obtained debt relief in the Customer Review.

(7) Execution of demands: how should the phrase "the time [at which] the demand was executed or the enforcement process completed" be interpreted?

46. The Bank has interpreted this phrase as referring to the actual repossession of the underlying security owed to the Bank and recovery of the asset value to repay the outstanding debt demanded. As a result, the Bank takes the view that, under paragraph 15.42(3), customers should be entitled to compensatory interest from the date of repossession and recovery of the asset value. Further, it is of the view that customers should only be compensated for the proportion of the outstanding debt which was in fact repaid as a result of the execution or enforcement.

47. As to the period in respect of which compensatory interest is payable, the Bank's understanding is correct: this should run from the date of repossession of the asset. The compensatory interest is intended to compensate customers for the loss of the asset, which occurred at the date of repossession.

48. As to whether customers should be compensated only for the proportion of the outstanding debt which was repaid, I do not agree with the Bank. Paragraph 15.42(3) requires the Bank to compensate customers for the amount of the debt outstanding at the date of repossession of the asset. This is necessary to ensure that customers whose debts were demanded or enforced are offered equivalent relief to those whose debts were not enforced.

49. This is perhaps best illustrated by way of an example:

    a. Customer X had a mortgage with HBOS for £1m. Following the failure of Customer X's business, the Bank enforced its security, repossessed Customer X's house and sold it for £600k.

    b. Customer Y had the same mortgage, but the Bank did not or was unable to enforce its security (perhaps because Customer Y successfully resisted repossession in the courts).

    c. Customer Y received a non-nil outcome in the Customer Review, and under its debt relief policy the Bank wrote off the full amount of Customer Y's

outstanding mortgage. Customer Y has retained his/her property and it is now mortgage free.

d. Customer X also received a non-nil outcome in the Customer Review, but he/she had no outstanding debt which could be written off under the Bank's debt relief policy. Customer X has lost his/her property.

e. In order to ensure that Customer X is treated equally to Customer Y, Customer X should be compensated for the full amount of the outstanding mortgage at the date of repossession of his/her property and recovery of the asset value.

PART B: Appeal mechanism for debt relief and de facto director issues

50. I have provided answers to the Bank's requests for me to interpret and clarify some aspects of the Cranston Report, so that the Bank may take them into account when making decisions on customers' applications for debt relief or for their claims to be assessed on the ground that they ought to be treated as de facto directors.

51. The Bank has consulted me about its approach to that decision-making. It is concerned to ensure that its approach fully and faithfully reflects my recommendations.

52. There will be a process not unlike the "minded to" decision which will be a feature of the Re-review Panel's procedure. The Bank will first inform the customer of its preliminary assessment of their application. The customer will be given an opportunity to produce further information, documentation or arguments before the Bank makes a final decision on their case.

53. The Bank has also asked me to recommend a simple appeals process for customers who are not happy with the Bank's final decision in their case.

54. Rory Phillips QC, who assisted me with my work on the Cranston Review, has agreed to oversee this appellate process and to determine the appeals. He will act independently of the Bank, as he has in the work which he has done so far with me. He will be assisted in his work by members of 3VB and, in the case of debt relief appeals, by Simon Kirkhope of FTI and his team.

55. In due course, further details of how the appeals process will operate will be sent to customers. I can say at this stage, however, that the appeals process will result in a final determination of their position, binding both on them and on the Bank.