FINAL NOTICE

To: **The Governor and Company of the Bank of Scotland**

Of: **Head Office**
The Mound
Edinburgh
EH1 1YZ

Date: **12 January 2004**

TAKE NOTICE: The Financial Services Authority of 25 The North Colonnade, Canary Wharf, London E14 5HS ("the FSA") gives you final notice about a requirement to pay a financial penalty.

1. THE PENALTY

1.1. The FSA gave you a Decision Notice dated 22nd December 2003 which notified you that, pursuant to section 206 of the Financial Services and Markets Act 2000 ("the Act"), the FSA had decided to impose a financial penalty on you in the amount of £1,250,000 in respect of breaches of Rules 7.3.2 and 2.1.1 of the FSA's Money Laundering Sourcebook ("ML").

1.2. You confirmed on 24th December 2003 that you do not intend to refer the matter to the Financial Services and Markets Tribunal.

1.3. Accordingly, for the reasons set out below the FSA imposes a financial penalty on you in the amount of £1,250,000 ("the Penalty").

2. RELEVANT STATUTORY PROVISIONS AND REGULATORY RULES

2.1. Section 2(2) of the Act includes among the FSA's regulatory objectives the reduction of financial crime.

2.2. Section 146 of the Act states:

The Authority may make rules in relation to the prevention and detection of money laundering in connection with the carrying on of regulated activity by authorised persons.

2.3. Rule 7.3.2 of ML states:

(1) A relevant firm must make and retain, for the periods specified in (2), the following records:

(a) in relation to the evidence of identity:

(i) a copy of the evidence of identity obtained under ML 3; or

(ii) a record of where a copy of the evidence of identity can be obtained; or

(iii) where it is not reasonably practicable to comply with (i) or(ii), a record of how the details of the evidence can be obtained;…

(b) a record containing details of every transaction carried out by the relevant firm with or for the client in the course of regulated activity.

(2) The specified periods are:

(a) In relation to evidence of identify, five years from the end of the relevant firm's relationship with the client.

(b) In relation to transactions within 1(b), five years from the date when the transaction was completed;

(c) …

(d) in any other case, five years from the obtaining of the information or the creation of the record.

2.4. Rule 2.1.1 of ML states:

A relevant firm must set up and operate arrangements, including the appointment of a money laundering reporting officer (MLRO) in accordance with the duty in ML7, which are designed to ensure that it, and any appointed representatives that act on its behalf, are able to comply, with the rules in this source book.

2.5. Section 206(1) of the Act states:

If the Authority considers that an authorised person has contravened a requirement imposed on him by or under this Act, it may impose on him a penalty, in respect of the contravention, of such amount as it considers appropriate.

3. REASONS FOR THE ACTION

Summary

3.1. In early 2002 the FSA conducted a review of anti-money laundering controls at major UK domestic retail firms, including HBOS plc ("HBOS"). Following the release of the findings of the review in August 2002, the FSA invited all major UK banks to conduct self-assessments of their anti-money laundering controls against those findings. The FSA asked for the results of these self-assessments to be reported by the end of December 2002.

3.2. On 27 December 2002, BoS reported to the FSA the results of its testing of its ability to retrieve and confirm the adequacy of its customer identification verification records. This testing was also part of BoS's own planned testing of its anti-money laundering controls. The results showed evidence of unacceptably high levels of non-compliance with BoS's record keeping procedures across BoS's Retail, Corporate and Business Divisions, although the problems did not appear in other BoS Divisions. As a result on 14 March 2003 the FSA appointed investigators under section 168 of the Act.

3.3. The investigation confirmed that BoS was unable to locate and retrieve customer identification records in relation to a significant proportion of accounts across its Retail, Corporate and Business Divisions.

3.4. As a result of the investigation, the FSA has concluded that BoS has contravened Rule 7.3.2 and Rule 2.1.1 of ML.

3.5. In so doing BoS has demonstrated failings that demand a substantial financial penalty. These failings are viewed by the FSA as particularly serious in light of the following factors:

(1) The very high failure rate - 55% - that occurred across three of BoS's main business divisions.

(2) The widespread nature of the breaches – the absence of effective systems and controls in respect of its record keeping policies and procedures, highlighted by the inability of BoS to determine conclusively the areas in which the breakdowns in record keeping procedures occurred.

(3) As a consequence of the widespread failures in its record keeping policies and procedures, BoS was unable adequately to monitor the effectiveness of the customer identification aspect of its anti-money laundering policies and procedures.

(4) The widespread nature of the breaches and the high levels of non-compliance in the accounts sampled, together with BoS' size in the retail market in which it operates, meant that there was a serious risk that BoS would not have been able to satisfy any enquiries or court orders from the appropriate authorities seeking disclosure of customer identification evidence.

(5) The failings occurred against a background where statutory requirements for firms to have in place anti-money laundering procedures, including procedures to keep records of customer identification documents, had been in place for over eight years and where, in anticipation of the FSA's new powers to make Rules relating to the prevention of money laundering with effect from 1 December 2001, there had been a greatly increased emphasis on preventing the use of the financial system for financial crime.

3.6. The FSA recognises the prompt and effective remedial action undertaken by BoS once it had identified its failings in 2002, the degree of co-operation demonstrated by BoS in relation to the FSA's investigation and BoS's efforts to resolve this matter expeditiously. These factors have resulted in the size of the financial penalty imposed being lower than it otherwise would have been.

Facts and Matters Relied On

The Statutory and Regulatory Background

3.7. Anti-money laundering requirements on financial sector firms were first imposed by the Money Laundering Regulations 1993 ("the Regulations"), which took effect on 1 April 1994. The Regulations require financial sector firms to have procedures for, among other things, the identification of their clients and the maintenance of records.

3.8. Further, from 1990 the Joint Money Laundering Steering Group, of which the British Bankers Association is a member, provided advice on best practice in anti-money laundering controls by issuing Guidance Notes for the Financial Sector ("the Guidance Notes"). Subsequent editions of the Guidance Notes took account of evolving best practice within the financial services industry. Since 1994 the Guidance Notes have provided advice and guidance on complying with the Regulations such that a court may take them into account in considering whether there has been a breach of the Regulations. Both the editions issued in 2001 reflected the provisions of ML that came into effect on 1 December 2001.

3.9. Prior to ML coming into force and in anticipation of the FSA's statutory objective to reduce financial crime, the FSA repeatedly stressed the importance of high standards of compliance with UK anti-money laundering requirements and that, once its new enforcement powers came into effect, they would be rigorously applied to deal with breaches of ML.

3.10. It is fundamental to the health of the United Kingdom's financial services industry that firms establish and maintain effective systems and controls for countering the risk that their products and services might be used to facilitate money laundering. Having sufficient evidence of the identity of its customers is a legal and regulatory obligation and considered by law enforcement agencies and the FSA to be an essential element of a firm's anti-money laundering controls.

3.11. Firms are required to maintain records of customer identification so as to facilitate the prompt provision of information to the relevant law enforcement agencies responsible for the investigation of money laundering. This is absolutely vital to assisting the

detection, investigation and prevention of financial crime by identifying individuals involved in money laundering and linking them with criminal funds attempting to pass through the UK financial system.

Bank of Scotland's Actions

3.12. BoS is an authorised deposit taking institution undertaking both retail and corporate banking along with a wide range of other permitted activities. It is a wholly owned subsidiary of HBOS.

The 2000 Audit

3.13. In September 2000 BoS Group Internal Audit ("GIA") found that while "know your customer" requirements were generally being followed, BoS's record keeping needed to be improved. GIA found that business units were unclear as to what records should be sent for imaging at the Document Reception Centre ("DRC"), the prime repository of documents used to verify customer identity, thus creating the potential that problems may occur in the subsequent retrieval of records.

3.14. Following the audit a number of recommendations were made to address the issues, including that completed identification evidence checklists be forwarded with account applications to the DRC, which would monitor their completion. However, the DRC was neither involved in the formulation of the recommendations nor aware of their existence and as a result was not involved in any monitoring of the completed identification verification checklists.

The 2002 Review

3.15. In October 2002, BoS's Group Regulatory Risk Department ("GRR") undertook a review to 'establish a baseline' for BoS's anti-money laundering identification verification records and to check whether BoS could comply with the range of orders under the Proceeds of Crime Act 2002 ("POCA"), by retrieving information in a timely manner. The exercise was part of BoS's planned testing and a response to the FSA's review of anti-money laundering controls at major UK domestic retail firms.

3.16. The GRR review in October 2002 focused on the BoS identification verification records retained by the DRC for the Retail, Corporate and Business Divisions of BoS. The review found that in 55% of the sample of accounts tested, such records could not be located.

3.17. On 27 December 2002, BoS informed the FSA that the GRR review had suggested that there were difficulties in locating identification verification records for BoS customers of Retail, Corporate and Business Divisions and detailed results of the GRR testing were reported to the FSA on 23 January 2003.

3.18. The FSA considers that the facts and matters described above and the failure rate stated in paragraph 3.16 demonstrate that BoS did not retain either a copy of the customer's identification evidence nor a record of where a copy of the evidence could be obtained, contrary to ML 7.3.2.

3.19. During December 2002 the Retail, Corporate and Business Divisions within BoS undertook further reviews to confirm whether the results of the GRR testing were accurate. All three Divisions confirmed that there was serious and widespread non-compliance with record keeping requirements. The reasons for the failings were subsequently summarised in a HBOS GIA report issued in February 2003.

3.20. The GIA report was graded red, signifying an "inadequate control environment". In summary, the report identified that the major failing was the many processes by which customer identification checklists progressed from the point of origination to point of completion of imaging. The report also concluded that there was an absence of effective controls to verify the adequate completion of checklists and that all relevant paper is ultimately imaged. Throughout all Divisions reviewed, there were no instances found of any audit trails to control the movement of paper from the point of origination to the point of processing and on to receipt and subsequent imaging at the DRC. BoS was therefore unable to be conclusive about the exact area(s) in which the breakdowns occurred.

3.21. The FSA considers that the conclusions of the GIA report regarding the reasons for the inadequate record keeping, together with the high proportion of accounts with inadequate records of customer identification evidence as stated in paragraph 3.16 above, demonstrate that BoS has failed to set up and operate arrangements to ensure that it is able to comply with the rules in ML, and has therefore breached Rule 2.1.1 of ML.

Remedial Action undertaken by BoS

3.22. BoS has acknowledged that the rates of compliance with account opening identification and related record keeping procedures in certain parts of BoS were unacceptably low. BoS has implemented across its Divisions action plans to address the shortcomings identified in its record keeping and customer identification procedures.

3.23. In December 2002 each Division was given responsibility to devise a set of initiatives to resolve the problems identified in respect of anti-money laundering record keeping. These initiatives were overseen by GRR and action plans for each Division were developed by the end of January 2003.

3.24. Since January 2003, BoS has regularly reported to the FSA its compliance rates in respect of the ongoing remedial actions. Overall the compliance rates in respect of its customer identification and record keeping procedures have improved considerably. The FSA is satisfied that the remedial action plan has appropriately addressed the problem.

4. RELEVANT GUIDANCE

4.1. The principal purpose of the imposition of a financial penalty is to promote high standards of regulatory conduct by deterring firms who have breached regulatory requirements from committing further contraventions, helping to deter other firms

from committing contraventions and demonstrating generally to firms the benefit of compliant behaviour.

4.2. In determining whether a financial penalty is appropriate and its level, the FSA is required to consider all the relevant circumstances of the case. ENF 13.3.3 indicates the factors that may be of particular relevance in determining the level of a financial penalty. These are discussed below.

4.3. As the breaches of ML 7.3.2 and 2.1.1 also constitute a breach of the Money Laundering Regulations 1993, the FSA has considered whether the case is appropriate for a criminal prosecution. In considering this, the FSA has applied the principles set out in ENF 15.5 and in the Code for Crown Prosecutors, namely the evidential and public interest tests. Having regard to those tests, the FSA has concluded that a prosecution would not be appropriate in this case.

5. FACTORS RELEVANT TO DETERMINING THE SANCTION

5.1. In determining that a financial penalty is appropriate and that the amount imposed is proportionate to BoS's breaches, the FSA considers the following factors to be particularly relevant.

The duration, frequency and nature of the breaches

5.2. BoS's GRR review in October 2002 revealed evidence of high rates of non-compliance across BoS's Retail, Corporate and Business Divisions.

5.3. The subsequent review in January 2003 by HBOS GIA revealed that the record keeping breaches were caused by widespread weaknesses in BoS's customer identification record keeping processes, procedures and controls; evidenced (and exacerbated) by the fact that GIA was unable even to determine conclusively the areas in which the breakdowns occurred.

5.4. The widespread nature of the breaches meant that BoS was unable adequately to monitor the effectiveness of the customer identification aspect of its anti-money laundering policies and procedures.

5.5. The widespread nature of the weaknesses and the high levels of non-compliance, together with the size of BoS in the retail market in which it operates, meant that there was a serious risk that BoS would not have been able to satisfy any enquiries or court orders from the appropriate authorities seeking disclosure of customer identification evidence. The FSA accepts, however, that there is no evidence to indicate that any such enquiries or court orders were frustrated by BoS's failings.

5.6. In September 2000, BoS GIA identified problems in respect of customer identification record keeping that were very similar in nature to those problems identified by the BoS GRR review in October 2002. This demonstrates that record keeping problems had existed for at least two years. If the recommendations made following the 2000 Audit had been fully implemented, it is likely that the subsequent problems would not have occurred to the same extent.

Conduct following the contravention

5.7. The FSA notes that BoS has devoted considerable resources to the issues identified and promptly and effectively implemented a robust remedial action plan across the whole of HBOS. The FSA is satisfied that the remedial action plan is addressing appropriately the weaknesses identified in BoS's customer identification record keeping processes, procedures and controls.

5.8. BoS afforded the FSA very good co-operation during the investigative phase of this matter, in particular in responding promptly to various document requests. BoS also involved GIA to review its document searches to verify that it supplied the FSA with all relevant information concerning its anti-money laundering procedures.

5.9. BoS has taken steps to settle this matter. This has helped the FSA to work expeditiously toward its regulatory objectives, which include reducing financial crime.

Previous action taken by the FSA

5.10. The FSA has had regard to previous cases involving breaches of ML. The FSA considers that the failure rates in this case are considerably higher than those previous cases. However, the FSA considers that some of the aggravating factors present in those cases are not evident in this case to the same degree.

6. CONCLUSION

6.1. Taking into account the seriousness of the contraventions and the risk they posed, but also having regard to the remedial steps taken and the co-operation shown, the FSA has decided to impose a financial penalty of £1,250,000.

7. IMPORTANT NOTICES

7.1. This Final Notice is given to you in accordance with section 390 of the Act.

Manner of payment

7.2. The Penalty must be paid to the FSA in full.

Time for payment

7.3. The Penalty must be paid to the FSA no later than 27th January 2004, being not less than 14 days beginning with the date on which the notice is given to you.

If the penalty is not paid

7.4. If all or any of the Penalty is outstanding on 27th January 2004, the FSA may recover the outstanding amount as a debt owed by you and due to the FSA.

Publicity

7.5. Sections 391(4), 391(6) and 391(7) of the Act apply to the publication of information about the matter to which this notice relates. Under those provisions, the FSA must publish such information about the matter to which this notice relates as the FSA considers appropriate. The information may be published in such manner as the FSA considers appropriate. However, the FSA may not publish information if such publication would, in the opinion of the FSA, be unfair to you or prejudicial to the interests of consumers.

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

FSA Contact

7.7. For more information concerning this matter generally, you should contact Andrew Bradley at the FSA (direct line: 020 7066 1450 /fax: 020 7066 1451).

Brian Dilley
Head of Deposit Taking and Financial Stability
FSA Enforcement Division