Dixon: FRC had no chance of success over HBOS KPMG audit probe

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The FRC's decision not to pursue further action against KPMG over its audit of HBOS is no sign of dysfunctional regulation, says Ross Dixon, partner at law firm Hickman & Rose

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Once again, the Financial Reporting Council (FRC) is subject to fierce criticism for its failure to find a culprit for a 2008 bank collapse. The Treasury Committee continues to protest and a number of analysts have suggested that the FRC has been captured by the finance industry and is running from a tough decision that would raise questions over its own adequacy.

Such criticism is not surprising. The Financial Services Authority (FSA) did not cover itself in glory through this episode and was eventually shut down in 2013. Public confidence in both banking and its regulators has been damaged by the failure to find and nail any culprits for the enormous losses that were sustained. However, the FRC is almost certainly right that it would not succeed in disciplinary action against KPMG.

There was a detailed investigation by the Financial Conduct Authority (FCA) and Prudential Regulation Authority into the HBOS collapse. Its 410-page report, published by the Bank of England in November 2015, makes the reasons for the collapse very clear.

The HBOS investment strategy was to build a large loan book with individual home-buyers, together with larger unsecured loans to property companies. Its loan to capital ratio was unusually high, and it was sunnily optimistic about the security for its loans.

This flew in the face of mounting evidence that borrowers were struggling to pay and that the size of its 'bad book' of impaired assets was becoming troublesome.

KPMG signed off on an impairment loss provision of £2bn at the end of 2007. By the time the dust settled on the 2008 crash, HBOS losses totalled £46bn. It is the size of the gap that is troubling the Treasury Committee.

The crash

The FRC's explanation for its decision was that KPMG did not foresee the crash any more than HBOS did. Nor, it has to be said, did the markets generally. The government, then led by Gordon 'no more boom and bust' Brown, and the FSA itself, also failed to foresee or forewarn of the impending financial disaster. Without the crash, HBOS may have traded on through a difficult period and weathered its difficulties.

With respect to the FRC, this is not an impressive piece of reasoning. The Bank of England report reveals that KPMG did not test the loans in the HBOS 'good book' to find out whether they had been correctly classified. KPMG accepted the HBOS view that they would hold up. This was in spite of evidence that HBOS had been dragging its feet badly on recognising impairments.

But this brings us to what is troubling about the FRC decision. In disciplinary proceedings the critical question for the Accountancy & Actuarial Discipline Board (AADB), which is one of the FRC's operating bodies, would be whether KPMG had failed to apply the standards current in 2008 on recognition of impairments on the balance sheet to produce a true and fair valuation.

The Bank of England's 2015 report has already stated that KPMG's approach was consistent with International Financial Reporting Standards (IFRS). This conclusion alone is sufficient to undermine any prospect of success before a disciplinary hearing.

But worse than this, for the prospects of success in any disciplinary hearing, the Bank of England's report is also highly critical of the FSA, which was exceedingly keen to maintain confidence in the banks following the 2007 collapse of Northern Rock, and which allowed prudence to slip below market confidence in ranking its priorities.

The resulting weakness for any attempt to discipline financial professionals has already been played out in the LIBOR issue. The public, media and politicians were appalled to discover that when individuals bankers made their LIBOR setting submissions they took account of the impact the rate would have on their own bank's positions.

However, when the RDC came to hear the first disciplinary charge against a rate-setter it had to accept that this this was done in accordance with industry practice and with the expectations of the British Bankers' Association. The banker in question was not only not found guilty of unprofessional conduct, but exonerated.

In effect, the need throughout the crisis to maintain market confidence trumped prudence every time. The same debate as to the priority of asset impairment recognition still continues, as evidenced in the recent spat between the LAPFF and the FRC.

The re-assurance which the public and the Treasury Committee can take is that financial regulators are not displaying any reluctance to take firm action in relation to current financial scandals. Notwithstanding this decision the FRC have ongoing investigations into a number of audits and their appetite for pursuing those auditing PLCs when things go wrong shows no sign of abating.

About the author

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