THE POLITICS OF FINANCIAL RISK, AUDIT AND REGULATION

A CASE STUDY OF HBOS

ATUL K. SHAH

Foreword by Ian Fraser, author of the no.1 bestseller:
Shredded: Inside RBS, the Bank that Broke Britain.

ROUTLEDGE

'In putting the bank's calamitous seven-year journey into its wider ideological context, this book will be a lodestar for future generations of students and scholars as they chart a course towards constructing a more sustainable, diverse, ethical and fair financial system.'–Ian Fraser

The biggest corporate failure ever in British history occurred in 2008 with very little forewarning. The management of HBOS, a major national bank with a long history of prudence prior to the merger in 2001, were allowed to act incompetently. Auditors and regulators failed to act, ignoring a key senior whistleblower, and the 'competitive' stock market failed to spot management failure in time.

This book is the first academic study of this collapse, uncovering some surprising evidence on the power and politics of large financial institutions. It details the processes and degrees to which financial challenge and regulation are undermined by this power. The research exposes a pro-active process of regulatory risk management by these institutions; the ease with which auditors and regulators can be captured; and how politicians and investors can be all too happy to hop on the stock market and management spin ride – with other people's money. The study questions the ideology and politics which supported and encouraged the management hubris, raising profound questions about the 'politics' of the academic disciplines of banking, finance and accounting today, and the theories they underpin.

This account of management gone wrong is essential reading for students, researchers and professionals involved in banking, finance, credit infrastructure, economics and management studies.

Atul K. Shah is a Chartered Accountant and member of the Institute of Chartered Accountants in England and Wales. He has a PhD in Accounting and Finance from the London School of Economics. He is also a Professor in Accounting and Finance at Suffolk Business School, Ipswich, UK.

BANKING AND FINANCE

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ISBN 978-1-138-04235-3

Routledge
Taylor & Francis Group

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Routledge titles are available as eBook editions in a range of digital formats

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A Case Study of HBOS

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Routledge
Taylor & Francis Group
LONDON AND NEW YORK

First published 2018
by Routledge
2 Park Square, Milton Park, Abingdon, Oxon OX14 4RN

and by Routledge
711 Third Avenue, New York, NY 10017

Routledge is an imprint of the Taylor & Francis Group, an informa business

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British Library Cataloguing in Publication Data
A catalogue record for this book is available from the British Library

Library of Congress Cataloging in Publication Data
A catalog record for this book has been requested

ISBN: 978-1-138-71430-4 (hbk)
ISBN: 978-1-138-04235-3 (pbk)
ISBN: 978-1-315-22875-4 (ebk)

Typeset in Bembo
by Taylor & Francis Books
Printed and bound by CPI Group (UK) Ltd, Croydon, CR0 4YY

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The Politics of Financial Risk, Audit and Regulation

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To all who seek a fairer, ethical finance and a banking and academic culture of honesty, integrity and contentment, endowed with servant leadership.

Foreword

When I interviewed James Crosby, chief executive of the newly merged Halifax Bank of Scotland back in December 2001, he insisted that HBOS represented something new, exciting and worthwhile in the world of British banking. Speaking in his corner office on The Mound, perched high above the Christmas shoppers on Edinburgh's Princes Street, the former actuary talked of reorienting his 60,000 'colleagues' so they could sell more aggressively and declared his goal was to 'open a Pandora's box' with a view to 'generating as much pain as possible for our competitors'.

What he perhaps didn't realise is that the evils he unleashed would also cause self-harm and wider economic and social destruction by bringing down the bank he led, with dire long-term consequences for many of its customers, staff and other stakeholders.

Halifax Bank of Scotland set out on a disastrous course pretty much from day one. Its leaders' inexperience, incompetence, greed and absence of ethics, combined with the unrealistic and hubristic goals they set themselves, made the bank's September 2008 collapse inevitable.

From its inauspicious birth on the eve of 9/11, the bank went hell for leather into the UK retail and corporate financial services markets, intent on boosting its market share in every sector in which it operated to 15 per cent or 20 per cent. Not long after I interviewed him, Crosby raised the stakes by increasing HBOS's return-on-equity target from an already stretching 17 per cent to 20 per cent.

As the Edinburgh headquartered bank ballooned its balance sheet from £275 billion in 2001 to £631 billion in 2008, a cavalier disregard for risk set in, coupled with an insatiable appetite for growth, inside what was a moral vacuum. The bank had no qualms about encouraging self-certified mortgage borrowers to commit mortgage fraud; about lending scores of billions of pounds to a bunch of seemingly clueless property tycoons, many of whom defaulted on their loans in 2008–9, without anything resembling proper credit checks; or about imposing a bunch of sleazy known embezzlers posing as "turnaround consultants" on between fifty and two hundred of its small and medium-sized corporate borrowers.

Over and above such activities, HBOS adopted a dangerously flawed and short-termist business model, funding the Topsy-like growth in its loan book

with wholesale funding – a policy that left it with a gaping £213 billion chasm between its loans and its deposits when the wholesale funding markets froze up after August 2007. The bank had left itself with nowhere else to go other than into a state-sponsored intensive care ward or into an anti-competitive merger with a slightly less reckless rival such as Lloyds TSB.

The Parliamentary Commission on Banking Standards, chaired by the conservative MP Andrew Tyrie, interviewed many of the bank's former directors and reached the conclusion that the chimera of success in the bank's early years gave rise to an internal arrogance and self-delusion:

> The culture was brash, underpinned by a belief that the growing market share was due to a special set of skills which HBOS possessed and which its competitors lacked. The effects of the culture were all the more corrosive when coupled with a lack of corporate self-knowledge at the top of the organisation, enabling the bank's leaders to persist in the belief, in some cases to this day, that HBOS was a conservative institution when in fact it was the very opposite.

In this book, Atul Shah brings home these and many other failures that contributed to HBOS's collapse – as well as the astonishing post-crisis failure of the British authorities to hold the individuals responsible to account.

The book differs from others on HBOS in calling out the bank's auditors, KPMG. Atul assiduously covers their failures, their conflicts, their failure to communicate their concerns to the regulator, their collusion with the Board – and therefore their key role in fuelling the bank's collapse. As he says, it's jaw-dropping that, eight years after HBOS's collapse, the Financial Reporting Council has not yet properly investigated KPMG's pivotal role in the HBOS disaster, or that the audit partners responsible haven't been hauled over the coals by their professional institutes.

But the uniqueness of the book lies in its unstinting critique of financial theory and ideology. Many academics shy away from tackling this, fearing that to challenge the status quo might hamper their careers and harm their institution's ability to raise money from the private sector. Others are too steeped in their models, assumptions and calculations to see the big picture. Even the various political and regulatory probes into HBOS steered clear of examining the half-baked ideological framework that underpinned its collapse – sometimes known as the 'Greenspan doctrine' – which included a strong belief in deregulation and a blind faith in the ability of unfettered free markets to boost global prosperity. Atul, however, does not pull any punches in this regard. Indeed, in putting the bank's calamitous seven-year journey into its wider ideological context, his book will, hopefully, be a lodestar for future generations of students and scholars as they chart a course towards constructing a more sustainable, diverse, ethical and fair financial system.

If financial education – and, indeed, finance itself – is to be reformed, it is essential that politics, culture, ethics and history become a core part of the

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curriculum. We continue to exclude such subjects from the core finance and MBA courses at our peril. We must never forget, for example, that Andy Hornby (second HBOS CEO) derived his own financial world-view from the MBA that he did at Harvard Business School – and that this was the intellectual framework he applied as he led HBOS to disaster.

Atul's book provides us with a timely reminder that the finance curriculum must change – moving away from a monocultural, technical discipline that promotes little other than greed, avarice and, indeed, financial disaster, towards becoming a less cynical and more inter-connected subject that will enable us to build a better financial system. It is ripe for disruption. We've already paid far too high a price from the financial collapses of 2007–9. This book illustrates not just how such disasters can be averted, but also how finance can be changed for good – and, indeed, how the Pandora's box so determinedly opened by James Crosby back in 2001 might once again be slammed shut. I strongly recommend it.

Ian Fraser
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November 2016

Acknowledgements

Foremost, I would like to thank HBOS whistleblower Paul Moore for his full cooperation with this study. He was generous with his knowledge, interviews and documents and correspondence which he had preserved meticulously. Encouragement for the research and framework for this study came from the indomitable Professor Prem Sikka, my friend and mentor, who has a distinguished record in analysing the modern industries of finance and accounting, and is a pioneer of tax justice. Research papers which led to this book were presented in seminars at University of Leicester, University of Suffolk, Cardiff Business School, and the British Accounting and Finance Association conferences at the London School of Economics and Manchester University. All the related research papers are available on-line at www.academia.edu/atulksha h, and 5000 people have read these papers to date. I would like to thank Professor Chris Humphries, Professor Yuval Millo and Nina Sharma for commenting on and encouraging the research. I would also like to thank the team which successfully campaigned for an investigation into the KPMG audit failure over HBOS – Brian Little, Ian Fraser, Tony Shearer, Prem Sikka and Paul Moore. Harriet Agnew at the *Financial Times* helped publicise our efforts in a timely way which enabled us to have maximum impact. Bloggers Richard Murphy and Ian Fraser helped this research reach a wide audience, and Carlos Tomero also generously helped promote the campaign. Professor Simon Hallsworth at University of Suffolk was very supportive and encouraging throughout. I am grateful to Ian Fraser for his foreword. My family were very patient with this project, tolerating books and papers all over the house, and a messy office. My friends Professor Al Bhimani, Professor Pat Arnold and Professor Janette Rutterford helped me stay focused on the research, and John Christensen and Nick Shaxson at the Tax Justice Network were also very supportive. My father and role model, Mr Keshavji Rupshi Shah, passed away just before this research was born, and I felt his spirit encouraging me all the way. My brother Ritesh also helped me a lot on this academic journey. My publisher at Routledge, Kristina Abbots, stayed supportive throughout and answered all my queries promptly. I am forever grateful for my Jain upbringing and inheritance, which has given me the wisdom to question with equanimity,

and the fearlessness to seek and reveal the truth, in spite of its consequences. Fortunately, the truth has also protected me.

Any weaknesses in the research, presentation and analysis belong to me – I beg your forgiveness.

Atul Keshavji Shah PhD ACA
October 2016

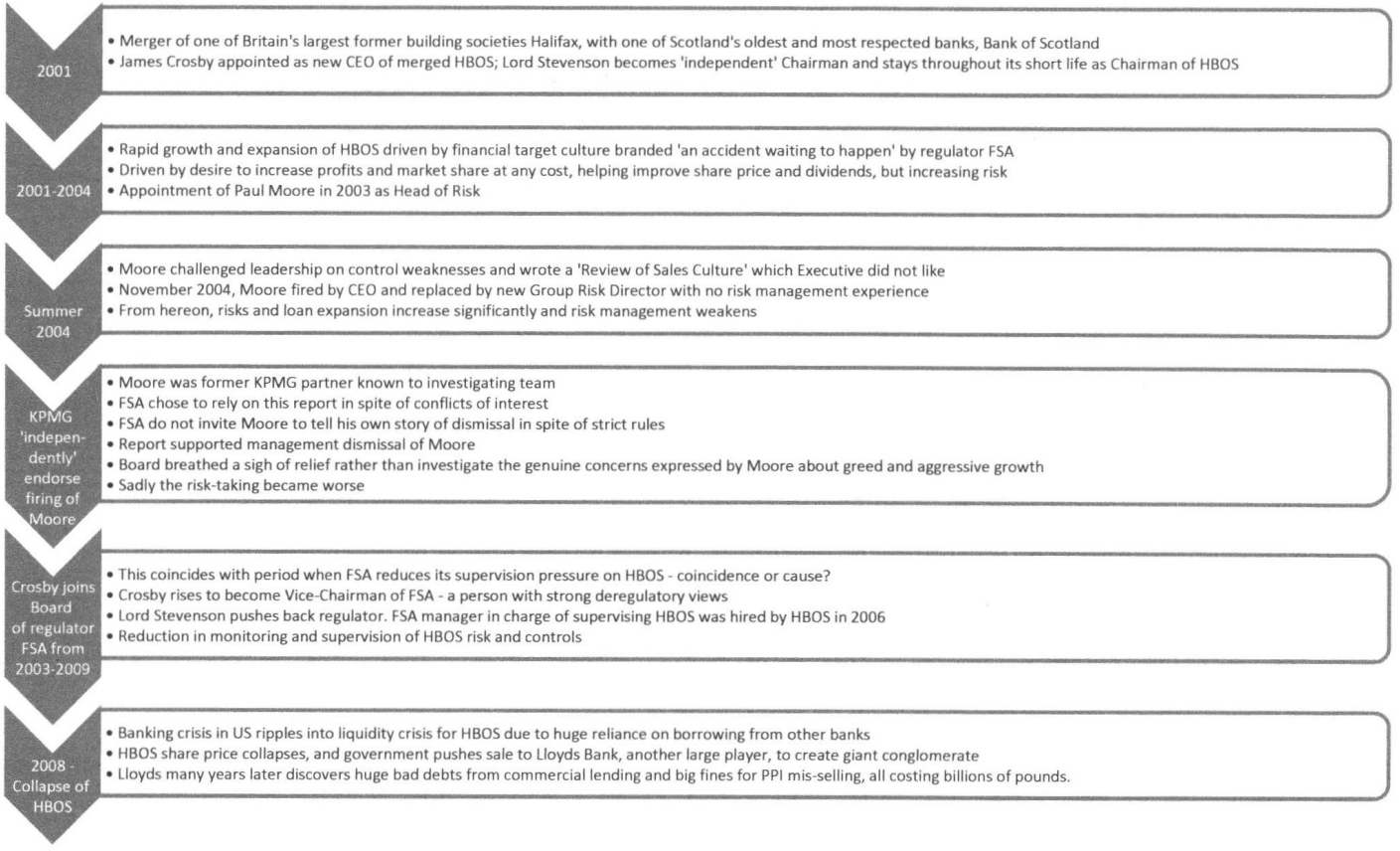

Table 1 HBOS timeline and key events
Source: Parliamentary investigations of collapse of HBOS

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