**IN THE MATTER OF:**

**THE EXECUTIVE COUNSEL TO THE FINANCIAL REPORTING COUNCIL**

**- and -**

**CHRISTOPHER GEE**

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# PARTICULARS OF FACT AND ACTS OF MISCONDUCT

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## Introduction

1. The Financial Reporting Council ("**the FRC**") is the independent disciplinary body for the accountancy and actuarial professions in the UK. The FRC's rules and procedures relating to accountants are set out in the Accountancy Scheme of 8 December 2014 ("**the Scheme**").

2. On 24 July 2013 the Conduct Committee of the FRC decided to refer the conduct of Members and a Member Firm in relation to the preparation and audit of the financial statements of Manchester Building Society ("**MBS**") for the years ending 31 December 2006 to 31 December 2012 for investigation by the Executive Counsel.[1]

3. The Respondent to these Particulars of Fact and Acts of Misconduct is Mr Christopher Gee ("**Mr Gee**"). Mr Gee was the Finance Director of MBS from December 2004 until April 2015 and is a member of the Institute of Chartered Accountants in England and Wales ("**ICAEW**").

4. This is the Executive Counsel's Particulars of Fact and Acts of Misconduct in relation to:

    (1) The preparation of financial statements by MBS which adopted hedge accounting purporting to be in compliance with IAS 39 in the financial years ending 31 December 2006, 2007, 2008, 2009, 2010 and 2011 ("**FY06, FY07,**

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[1] References to "Member Firm" and "Member" in this document relate to the definition as set out in paragraph 2 (1) of the Scheme, references to 'member firm' and 'member' denote their membership of the ICAEW.

**FY08, FY09, FY10, FY11 and FY12**") when MBS was not entitled to adopt hedge accounting in its financial statements as it did not comply with the criteria for hedge accounting set out in IAS 39 in any of those financial periods. The final version of the FY12 financial statements did not incorporate hedge accounting.

(2) The failure of Mr Gee to identify breaches of accounting standard IAS 39 by MBS in FY06, FY07, FY08, FY09, FY10, FY11 and FY12 and, in respect of the periods FY06 to FY11 the failure of Mr Gee to identify the effect of those breaches on the financial statements of MBS for each of those periods. The final version of the FY12 financial statements did not incorporate hedge accounting.

**Misconduct under the Scheme**

5. Paragraph 2(1) of the Scheme provides that an Adverse Finding, (referred to at paragraph 2 above) is a finding by a Disciplinary Tribunal that a Member or Member Firm has committed "Misconduct", that is defined as: "an act or omission or series of acts or omissions, by a Member or Member Firm in the course of his or its professional activities (including as a partner, member, director, consultant, agent, or employee in or of any organisation or as an individual) or otherwise, which falls significantly short of the standards reasonably to be expected of a Member or Member Firm or has brought, or is likely to bring, discredit to the Member or the Member Firm or to the accountancy profession."

**The Respondent**

6. Mr Gee qualified as a Chartered Accountant in 1993 and was admitted to the ICAEW in 1994. Mr Gee was appointed Finance Director of MBS in December 2004 and continues in that position to date. Mr Gee had prior experience as a group financial controller.

7. As Finance Director, Mr Gee had primary responsibility within MBS for the preparation of the financial statements of MBS. Mr Gee also sat on the Asset and Liability Committee ("**ALCO**"), the Credit Committee and the Risk Committee.

**The Relevant Standards of Conduct**

8. The standards of conduct reasonably to be expected of Mr Gee as a member of the ICAEW in the conduct of his role as Finance Director of MBS included those set out in: the Fundamental Principles and Statements contained in the Guide to Professional Ethics; and from 1 September 2006 the Code of Ethics issued by the ICAEW; and in

the ICAEW's Guidance for Members In Business applicable from 1 September 2006 (the "**2006 Guidance**"); and from 1 January 2011 onwards the Code of Ethics issued by the ICAEW and in the ICAEW's Guidance for Members In Business applicable after that date (the "**2011 Guidance**"). The Fundamental Principles apply to all members and member firms of the ICAEW. They are framed in broad and general terms and constitute basic requirements of professional behaviour. The Executive Counsel will refer to and rely on the applicable Fundamental Principles and Statements as extracted and annexed to these Particulars of Fact and Acts of Misconduct as Annex A. Annex A contains the Fundamental Principles and Statements for the whole of the relevant period from 2006 to 2013.

**The Respondent's Misconduct**

9. As particularised below, the allegations of Misconduct relate to failures on the part of Mr Gee to comply with the required standards of conduct in connection with the work undertaken to prepare MBS for the adoption of hedge accounting pursuant to IAS 39, the ongoing adoption of hedge accounting by MBS in compliance with IAS 39 for the period from 1 March 2006 to March 2013 and the preparation by MBS of the financial statements for FY06 to FY12 inclusive. The final version of the FY12 financial statements did not incorporate hedge accounting.

**Manchester Building Society**

10. MBS is a mutual building society, authorised by the Prudential Regulatory Authority ("**PRA**") and regulated by the Financial Conduct Authority and the PRA. It is subject to the Building Societies Act 1986. According to its website, MBS is the UK's 19th largest building society. Based in Manchester City Centre, the Society has over 22,000 savers and 3,750 borrowers.

11. MBS sold a range of mortgage products. Some of the mortgage products produced income streams by reference to a fixed interest rate:

    (1) Some mortgage products reverted to a variable rate of interest after an initial fixed rate period. The fixed rate products typically provided a fixed period of 3, 5 or 10 years and were GBP denominated. MBS had a limited book of 25 year fixed rate mortgages.

    (2) MBS sold "lifetime mortgage" products, which were GBP denominated in respect of UK properties and Euro denominated in respect of properties located in the EU.

12. The lifetime mortgages were marketed to property owners in their fifties, sixties, seventies and eighties. The owners were paid a lump sum loan, secured on their property, and paid no interest or principal repayments until the owners died, moved from the property or sold the property, each of which triggered the redemption of the mortgage. Interest was added to the loan balance and the entire loan was repaid on redemption. By reason of the terms of the loan, the lifetime mortgages were of an uncertain duration.

13. MBS paid depositors both variable and fixed rates of interest, but received payments on the fixed rate mortgage book at the rates fixed in the underlying mortgages. MBS therefore ran the risk of the variable rate payable to depositors increasing and the income from the fixed rate mortgages being insufficient to cover interest due to deposit holders.

14. MBS entered into interest rate swaps to mitigate this risk. The interest rate swaps purchased by MBS were straightforward products. Most of the swaps were Bermudan Options, which meant that the parties could exercise, break clauses at defined periods prior to the maturity date. From 2006 to 2012 MBS was a party to around 50 swap agreements with periods ranging between 3 year and 50 years.

**Hedge Accounting**

15. From FY05 MBS needed to prepare its financial statements under standards set out in the International Financial Reporting Standards ("**IFRS**"). MBS prepared its accounting records and management accounts under UK Generally Accepted Accounting Practice ("**UK GAAP**"). MBS would then make adjustments to the management accounts to prepare its financial statements.

16. In very general terms items in financial statements are shown either:

(1) At amortised cost to the company, i.e. the costs incurred by the company in acquiring the item, with certain adjustments; or

(2) At fair value, which most often means the current market value of the item.

17. Derivative products such as swaps typically are shown in financial statements at their fair values. For the party receiving payments based on the variable interest rate, an increase in current and expected variable rates typically leads to an increase in the market value of the swap, and conversely a decrease in current and expected variable rates typically leads to a decrease in the market value of the swap. The value of the swap is also affected by the duration of the swap. Changes in the market value of the

swaps are reflected in the profit and loss.

18. Mortgages are normally shown in financial statements at amortised cost, with certain adjustments. The market value of a fixed rate mortgage would decrease if there was an increase in current or expected variable rates and would increase if there was a decrease in current expected variable rates. Since mortgages are normally shown at cost, there would be no adjustment made in financial statements for changes in market value of the mortgages.

19. Fair value hedge accounting allows a party who holds a derivative product to hedge an asset to adjust the carrying value of the asset in the financial statements by the change in its market value attributable to the risk that has been hedged by the derivative. The impact on the reported profit or loss deriving from the change in fair values of the derivative is countered by the adjustments to the asset. Hedge accounting reflects the commercial reality that movements in the value of the derivatives are countered by movements in the value of the assets. This type of hedge accounting is called fair value hedge accounting as it addresses the volatility on the profit and loss account caused by changes in fair value of an element in the balance sheet. In the case of MBS, hedge accounting addressed the difference in the accounting treatment between the mortgages and swaps purchased to hedge against interest rate risks on the mortgages.

20. In the context of a financial institution such as a building society, hedging activity can be a significant part of that entity's risk management. A statement in the financial statements that MBS had adopted hedge accounting would indicate that the society had adopted an effective means of mitigating income statement volatility arising from changes in interest rates. A knowledgeable user of the accounts, such as a regulator, is likely to understand from such a statement that the impact of rate volatility on the capital of MBS was also being mitigated.

21. Hedge accounting is optional and IAS 39 sets out specific requirements before an entity can apply the standard and ongoing conditions which must be satisfied to permit ongoing hedge accounting. In particular, the criteria for assessing whether the hedge is effective, referred to as "effectiveness testing", is very specific (although the criteria for performing the effectiveness testing are not). Hedge accounting under IAS 39 is a technical and complex area of accounting and therefore there is a higher risk of error in its application.

**MBS adopts Hedge Accounting**

22. MBS sought to apply hedge accounting for the FY05 period. Mr Gee and his team researched the scope and effect of IAS 39. Mr Gee described his position as initially being "in the dark" in 2005 and that he did not have access to meaningful external information. Mr Gee acknowledged that the MBS internal finance team did not have a great deal of experience on IAS 39 compliance.

23. Paragraph 88(a) of IAS 39 requires that appropriate documentation be in place at the inception of the hedging relationship.

24. In a meeting on 5 January 2006 attended by Mr Alastair Nuttall and [redacted], of Grant Thornton and [redacted], the Financial Controller of MBS, the adoption of hedge accounting and the documentation required for this was discussed. On 6 January 2006, Mr Nuttall sent [redacted] an email attaching some guidance on fair value hedge accounting. In his email Mr Nuttall noted that the attached documents provided a good guide as to what was required.

25. In early 2006, Mr Gee oversaw the drafting of a policy (the "Policy") together with [redacted] that purported to summarise the hedging activities of MBS and how MBS would apply hedge accounting. The draft Policy was provided to GT around the end of January 2006.

26. As requested by Mr Gee, on behalf of the MBS board, in early 2006 GT approved the Policy. Mr Nuttall of GT sent an email to Mr Gee on 11 April 2006 stating that GT had reviewed the Policy and *"I am happy to confirm that I am satisfied that it meets the criteria set out in IAS 39"*. GT's Key Issues Memorandum for FY06 dated 22 February 2007 records that *"During 2006* [MBS] *had implemented a formal hedging policy that meets the requirements of IAS 39"*. GT's Key Issues Memorandum affirmed to the MBS Board and Audit Committee that GT "*reviewed* [MBS'] *hedging policy in February 2006 and concluded that it met the requirements of IAS 39. At that time* [GT] *also determined that the methodology to be adopted to assess the changes in interest rate fair value of mortgage assets was acceptable*." GT's Key Issues Memorandum also stated that during the course of GT's final audit visit GT had:

- "*reviewed evidence that interest rate fair value hedges have been administered in accordance with* [MBS] *policy and IAS 39*
- *audited SWAP and fixed rate mortgage asset interest fair values as calculated by* [MBS's] *Quantum Treasury Management System*

- *determined hedge effectiveness had been correctly assessed*
- *ensured the disclosures within the accounts comply with the requirements of IAS 39*"

Following GT's presentation of the Key Issues Memorandum at the Board meeting on 22 February 2007, the Board approved MBS' Annual Report & Accounts for FY06.

27. On 8 February 2006 Mr Nuttall informed Mr Gee by email that MBS could not apply hedge accounting for the FY05 period, primarily because the Policy had not been prepared at the start of the financial period for which MBS intended to apply hedge accounting.

28. Mr Gee replied the same day and asked Mr Nuttall to provide a "tick list" discussed previously, so that he could ensure that the required paperwork could be prepared. Mr Nuttall responded on 10 February 2006 attaching the relevant guidance. He also responded to the query Mr Gee had raised regarding the timing of implementation of hedge accounting. Mr Gee confirmed that MBS would work on the document.

29. On 29 March 2006, Mr Gee emailed Mr Nuttall with a number of questions on various topics. In relation to hedge accounting, he said that he had passed a revised copy of the Policy to [redacted], and asked for Mr Nuttall's comments on it. Mr Gee stated that the Policy had already been approved by the MBS Risk Committee on 14 February 2006 (although in actual fact the Committee had only accepted the policy as its first draft).

30. By an email to Mr Gee dated 11 April 2006 Mr Nuttall stated that he had reviewed the Policy and that it satisfied the criteria of IAS 39.

31. The contemporaneous documents are inconsistent and unclear as to the precise date at which MBS adopted hedge accounting. Hedge accounting was adopted by MBS by 1 March 2006 at the latest. For the purposes of these Particulars it is assumed that MBS adopted hedge accounting on 1 March 2006, as any difference in timing is not material to the allegations made herein.

32. The Policy formed an appendix to the MBS Financial Risk Management Policy. Between 2006 and 2012 it was not subject to any significant substantive revisions. In 2012 the Policy was revised to deal with the impact of break clauses in the swaps

purchased by MBS.

**MBS Hedging Activity – Purchases of Long-Term Swaps in Period 2006-2012**

33. From 2006 to 2012 MBS was a party to around 50 swap agreements that it used to hedge the interest rate risk relating to the fixed interest rate mortgages. During this period MBS entered into a total of 12 long term swaps with durations of between 40 years and 50 years. These long duration swaps were designated to mortgages with fixed interest periods and to lifetime mortgages. Lifetime mortgages did not have a fixed maturity date, but were allocated a notional maturity date by MBS. These designated mortgages ended or were likely to end significantly earlier than the maturity dates of the swap. The Policy did not refer to such long term swap agreements or to lifetime mortgages.

34. The commercial rationale for entering into the longer dated swaps was discussed in Risk Committee meetings on 16 May 2006 and 16 January 2007 and in Board meetings on 25 January 2007 and 22 March 2007. MBS determined it could derive cash flow advantages by entering into the longer 50 years swaps compared to 20 year swaps.

35. A memorandum prepared by [redacted] dated 12 March 2007 provided to all MBS board members ahead of the 22 March 2007 Board Meeting stated:

> *"For some time the Society has been hedging long term equity release mortgages with 50 year swaps where MBS pays the swap fixed rate and receives LIBOR. It is extremely unlikely that any of the hedged mortgages will exist for a term of 50 years and perhaps a term of 20 years would be more appropriate. 20 year swap rates are however significantly higher than those of 50 years (a difference of around 0.5%)."*

36. The designation of mortgages to these swaps was inconsistent with the Policy. The Policy stated that the maturity dates of the swaps and the mortgages would be similar and did not consider the substitution of forecast mortgages, i.e. a mortgage not yet in existence.

37. Each year, for the purposes of the yearly audit of MBS' financial statements, MBS provided GT with information concerning the swaps and hedges. That included Reuters month end market rates, swap and hedges reports, fair value of swaps and mortgages, derivatives reports, marked to market valuation of hedges and details of the fixed rate mortgages designated to be hedged. GT maintained IFRS Files (the "IFRS Files"). These were hard copy files prepared by GT containing audit work and

audit evidence for IFRS adjustments to the accounts of MBS. The IFRS Files included the audit work and evidence relating to hedge accounting.

38. A summary based on schedules in the IFRS Files of the swaps used for hedging is as follows:

| Year | 2006 | 2007 | 2008[2] | 2009 | 2010 | 2011 |
|---|---|---|---|---|---|---|
| Notional amount of interest rate swaps | £40.5m | £73.5m | £149.5m | £196.5m | £154.0m | £180.2m |
| Notional amount of interest rate swaps with periods of 40 years or more | £28.5m | £51.5m | £71.5m | £76.5m | £76.5m | £76.5m |

39. An incorrect statement in the financial statements that there was compliance with criteria required by a standard for applying a certain accounting policy can be material, particularly when the impact of a policy may become material in the future by reason of matters outside the control of management. Materiality is not limited to the adjustments in question for the financial year but also includes consideration of the overall exposure risks of derivatives. Regardless of the numerical value of the adjustment, hedge accounting was a material consideration in every audit year. The adjustments resulting from hedge accounting became numerically material in FY08.

40. The use of 50 year swaps to hedge mortgage products provided commercial benefit to MBS. For example, MBS was able to purchase 50 year swaps which were between 40 and 45 basis points cheaper than the equivalent 25 year swap. The benefits of the longer swap strategy were described to the Board in May 2006 [redacted], as offering a "*material commercial advantage*".

**MBS Hedging Activity – Calculation of Fair Values and Adjustment to Mortgages**

41. MBS calculated the fair value of the swaps in order to include them at this value in their financial statements. Swaps would need to be shown at fair value in the financial

2 These are the numbers contained in the Schedules in the IFRS Files. In fact the 2008 schedules, when matched to the swaps understated the notional amount of interest rate swaps with periods of 40 years or more by £5m. The figure included in the Schedule should therefore have been £76.5m.

statements whether or not hedge accounting was applied.

42. In order to apply hedge accounting, MBS also needed to calculate the change in the fair values of the hedged mortgages attributable to interest rate risk which was hedged by the swap.

43. Calculation of the changes in fair value was required at two stages:

(1) First, to test the effectiveness of the hedge - the movement in the fair value of the swap needs to be similar to the movement in the fair value of the mortgage attributable to interest rate risk; and

(2) Second, when the hedge is found to be effective, to provide the adjustment to the value of the hedged mortgages shown in the financial statements.

44. The effectiveness testing undertaken by MBS produced figures that indicated substantial effectiveness. However that impression was incorrect, as it was based upon the artificial attribution of the maturity dates of the swaps to the mortgages being hedged by those swaps.

45. MBS used Quantum software to calculate the fair value of the swaps and the adjustment for the mortgages. The maturity dates that were used to calculate the fair value of the mortgages were that of the swap and not the maturity date of the mortgage. This was the approach of MBS even where there was a significant difference between the maturity date of the swap and the maturity date of the mortgages.

46. The designated mortgages were revalued by MBS as if they were Gilts. In the context of lifetime mortgages this process was inappropriate because lifetime mortgages had no periodic payments, in contrast to a Gilt. Rather in lifetime mortgages interest is rolled up into the mortgage balance. The fair value of an instrument which pays a cash interest coupon will be different from one where interest is rolled up even if all the other terms match. Using the Quantum Gilt model would have been likely to produce incorrect valuations of lifetime mortgages.

47. MBS tested the effectiveness of the hedge by comparing the change in fair value of the swap with the change in the fair value of the mortgage attributable to the interest rate risk. IAS 39 mandates that the fair values over the period must be within 80% to 125% of each other in order for the hedge to be considered effective.

48. For the periods from 2006 to 2012, MBS did not comply with the requirements of IAS

39 and therefore was never entitled to use hedge accounting in these periods.

49. The key areas in which MBS did not comply with IAS 39 were:

(1) Documentation.

(2) Designation.

(3) Retrospective effectiveness testing.

(4) Prospective effectiveness testing.

50. The categories of non-compliance are particularised at paragraphs 56 to 78 below.

51. As stated by Mr Gee in interview, at no time prior to March 2013 did Mr Gee realise that the swaps entered into by MBS were not effective for the purposes of hedge accounting under IAS39.

**The Discovery of Problems with Hedge Accounting by MBS**

52. The MBS Audit Committee meeting which dealt with issues arising on the FY12 financial statements took place on 5 March 2013. At that meeting Mr Bartlett, the GT Engagement Partner for FY12, for the first time raised his concerns over MBS' approach to hedge accounting. It was quickly realised that MBS had not complied with the requirements of IAS 39 at any time between 2006 and 2012.

53. Over the next few days MBS sought independent advice which confirmed that MBS had not complied with the requirements of IAS 39. On 12 March 2013 MBS informed the PRA of the likelihood of a substantial restatement being made in MBS 2012 financial statements.

54. MBS's 2012 financial statements included a restatement of prior years' reported figures. A summary of the impact of the hedge accounting on the value of mortgages in MBS's financial statements is as follows:

| Year | Adjustment to hedged mortgages in the financial statements |
|---|---|
| 2006 | -£0.361m |
| 2007 | -£0.862m |
| 2008 | £26.169m |
| 2009 | £8.873m |

| | |
|---|---|
| 2010 | £14.161m |
| 2011 | £37.667m |

55. The cumulative effect of the restatement of financial position significantly depleted the reserves of MBS. After allowing for tax, the restatements resulted in a reduction of £28.712m on retained earnings as at 31 December 2011 of £38.418m, a reduction of 75% on equity prior to restatement. The regulatory capital was considered by the MBS Board to be one of the most important key metrics of the Society and the adjustments arising from the restatement had a very significant impact on the Society's regulatory capital.

56. As a result of the discovery of the hedge accounting problems, MBS had to take urgent action to raise sufficient capital to secure its existence and protect its members. Specifically, in April 2013 MBS issued £18m of new equity in the form of Profit Participating Deferred Shares. The raising of the capital allowed the directors to state that they were satisfied that they could proceed as a going concern and satisfy the PRA's regulatory capital requirements.

## ALLEGATIONS

### ALLEGATION 1 – THE ADOPTION OF HEDGE ACCOUNTING IN 2006

In relation to the preparation of a policy that purported to summarise the hedging activities and how MBS would apply hedge accounting and the adoption of IAS 39 by MBS, the conduct of Mr Gee fell significantly short of the standards reasonably to be expected of a Member in that:

1.1 Mr Gee failed to ensure that MBS had in place the necessary documentation to ensure that MBS was entitled to commence hedge accounting under IAS 39; specifically the Policy did not comply with the requirements of IAS 39 and Mr Gee failed thereby to act in accordance with Fundamental Principle 3 "Competence" and Fundamental Principle 4 "Performance" in the Guide to Professional Ethics and the ICAEW's Guidance for Members in Business.

1.2 Mr Gee failed to ensure that the Policy accurately represented the hedging activities and business of MBS and Mr Gee failed thereby to act in accordance with Fundamental Principle 3 "Competence" and Fundamental Principle 4 "Performance" in the Guide to Professional Ethics and the ICAEW's Guidance for Members in Business.

1.3 Mr Gee failed to ensure that he had sufficient knowledge of the requirement of IAS 39 and/or failed to ensure that MBS had sought appropriate expert advice on the steps to be taken to adopt hedge accounting under IAS 39 and Mr Gee failed thereby to act in accordance with Fundamental Principle 3 "Competence" and Fundamental Principle 4 "Performance" in the Guide to Professional Ethics and the ICAEW's Guidance for Members in Business.

**Particulars**

57. Paragraph 88(a) of IAS 39 and paragraph AG107 of the application guidance at Appendix A to the standard requires that before hedge accounting can be applied, there must be appropriate documentation setting out details of the hedging relationship including details of:

(1) The hedging instrument;

(2) The hedged item or transaction;

(3) The nature of the risk being hedged; and

(4) How the hedging instrument's effectiveness in offsetting the risk will be assessed, retrospectively and prospectively.

58. As set out at paragraph 25 above, Mr Gee, oversaw the drafting of the Policy which purported to satisfy the requirements of IAS 39. The Policy was however incomplete, inaccurate and ambiguous and fell significantly short of the minimum requirements of the standard in that:

(1) The Policy did not identify adequately how retrospective effectiveness testing would be undertaken. The Policy referred to the Quantum Treasury System ("Quantum") but gave no explanation of what this system did. The Policy did not identify the methodologies adopted for effectiveness testing.

(2) The Policy was internally inconsistent on how frequently effectiveness testing would be carried out. Paragraph 3(2) (f) on page 5 of the Policy stated that the effectiveness tests would be carried out twice a year. However Appendix 4 of the Policy stated that effectiveness would be tested monthly.

(3) The Policy did not refer to prospective testing.

(4) The Policy did not identify whether each hedge would be a portfolio hedge or a hedge over a group of assets. The appropriate treatment would vary depending on which basis was selected, so proper identification of the hedging basis was necessary.

(5) The Policy primarily referred to 3 year fixed rate products and the characteristics and profile of those products. It did not address the hedge accounting for lifetime products or other longer dated products.

(6) The Policy did not identify that MBS would be substituting mortgage products within existing swaps on an ad hoc basis, or designating, de-designating and re-designating mortgage products to hedges or provide sufficient (or any) explanation of the monitoring, updating and measurement of hedge effectiveness to permit dynamic hedging.

59. Further to the points particularised at 58(5) above, the Policy gave an incorrect impression as to the hedging activities undertaken by MBS. For example:

(1) Section 3(a) of the Policy stated that the swaps taken out to hedge against 3 year fixed rate mortgages would be for a duration of 3 years. This statement

gave the impression that MBS would hedge fixed rate products with swaps of the same duration as the fixed rate product.

(2) Section 3(a) of the Policy stated that it was not expected that fixed rate mortgages would redeem within the contractual fixed period. While this statement may have been true in respect of 3 year fixed mortgages, it gave the incorrect impression that it was not anticipated that MBS would suffer impairment and/or effectiveness issues in relation to the swaps purchased to hedge its fixed rate products. In fact in respect of longer fixed rate products and lifetime mortgages there was a significant prospect that a material number of mortgages allocated to a swaps would be terminated prior to the contractual expiry date of the interest rate swap.

(3) Section 3.2(b) and s.3.2(c) of the Policy stated “The hedge will be taken for a period which will match against the fixed rate maturity profile of the portfolio of mortgages being hedged against”. The statement was incorrect as MBS hedged mortgages against interest rate swaps with significantly different maturity profiles than the mortgages against which those swaps were hedged.

(4) Section 3.2(e) stated “One or more SWAPs can be taken with maturities equal to or similar to the fixed rate period of the mortgage portfolio which they are hedging”. The statement was incorrect as MBS hedged mortgages against interest rate swaps with significantly different maturity dates than the mortgages against which those swaps were hedged and lifetime mortgages which were of an uncertain duration.

(5) Section 3.2(g) stated in respect of retrospective effectiveness testing “The Society will use the Quantum Treasury System (QBS) to calculate the fair value of both the hedges and the hedged items. The Society will follow these procedures to obtain the fair value of both the hedges and the hedged items”. MBS did not use the Quantum system to obtain the fair value of the hedged items in respect of hedged items which had maturity dates significantly different to the maturity dates of the swaps which purported to hedge those items. Rather MBS used Quantum to assess the fair value of items equivalent in terms to the hedged items but with a hypothetical maturity date which matched the maturity date of the swap. In this process, MBS revalued the designated mortgages using Quantum as if the designated mortgages were Gilts. In respect of lifetime mortgages this was inappropriate as the lifetime mortgages did not have

periodic payments, as interest was rolled up into the mortgage balance. The fair value of an instrument which pays a cash interest coupon will be different from one where interest is rolled up even if all other terms match. Further the summary of the application of the use of the Quantum system at section 3.2(g) (i) to (iv) gave the incorrect impression that MBS would be using the system to calculate the fair value of the hedged items.

(6) Appendix 1 of the Policy indicated that the mortgages hedged by a swap would be products with a maturity date within one month of the maturity date of the swap. This impression was inaccurate as MBS would hedge items with significantly different maturity dates to the mortgages against which those swaps were hedged.

(7) Appendix 4 of the Policy made substantially similar inaccurate statements as those summarised above at sections AG114 (b), AG114(c), AG114 (e), AG114 (f), AG114 (g), AG114 (i), AG116, AG117, AG119(c), AG119 (d), AG119 (e), AG121, AG122, AG124, AG125, AG126, AG127, AG128, AG129, AG130 and AG131.

60. Mr Gee accepted in his interview that he and his team did their own research on the scope and effect of IAS 39. As mentioned at paragraph 22 above, Mr Gee described his position as being “in the dark” in 2005. Mr Gee acknowledged that the MBS internal finance team did not have a great deal of experience on IAS 39 compliance. In order to conduct himself to the professional standards expected of him, Mr Gee ought to have ensured he or members of his finance team obtained more detailed education on the application of IAS 39 or obtained additional external specialist assistance on the steps which needed to be taken by MBS to adopt and then comply with IAS 39. Any advice obtained should have been formal and documented.

61. Mr Gee and the MBS Board relied on the approval provided by GT in relation to the Policy and the unqualified audit opinions provided by GT on MBS’s financial statements for FY06 to FY011. As set out in paragraph 26 above, however, such reliance is not sufficient, given that it is the responsibly of the directors, in particular the Finance Director, to decide on appropriate accounting policies.

**ALLEGATION 2 – THE RELIANCE UPON HEDGE ACCOUNTING IN THE FINANCIAL STATEMENTS FOR FY06 TO FY12 AND BETWEEN MARCH 2006 AND MARCH 2013**

Between March 2006 and March 2013 in respect of the application and review of hedge accounting and in relation to the preparation and approval of the financial statements for periods FY06 to FY12 the conduct of Mr Gee fell significantly short of the standards reasonably to be expected of a Member in that:

2.1 Mr Gee included within the financial statements a statement that MBS complied with the criteria set out in IAS 39 for adopting hedge accounting or permitted such a statement to be included in the financial statements, when at no time in the relevant period had MBS complied with the requirements of IAS 39 for hedge accounting and Mr Gee failed thereby to act in accordance with Fundamental Principle 3 "Competence" and Fundamental Principle 4 "Performance" in the Guide to Professional Ethics and Fundamental Principle C "Professional Competence and Due Care" in the Code of Ethics and the ICAEW's Guidance for Members in Business.

2.2 Mr Gee failed to review the Policy adequately and correct the inaccurate statements in the Policy and Mr Gee failed thereby to act in accordance with Fundamental Principle 3 "Competence" and Fundamental Principle 4 "Performance" in the Guide to Professional Ethics and Fundamental Principle C "Professional Competence and Due Care" in the Code of Ethics and the ICAEW's Guidance for Members in Business.

2.3 Mr Gee failed to review adequately the designation of fixed rate products to interest rate swaps for the purposes of hedge accounting adequately or at all, failed to ensure that any such designation complied with IAS 39 and failed to identify that the designation of fixed rate products to interest rate swaps for the purposes of hedge accounting undertaken by MBS did not comply with the requirements of IAS 39 and Mr Gee failed thereby to act in accordance with Fundamental Principle 3 "Competence" and Fundamental Principle 4 "Performance" in the Guide to Professional Ethics and Fundamental Principle C "Professional Competence and Due Care" in the Code of Ethics and the ICAEW's Guidance for Members in Business.

2.4 Mr Gee failed to review adequately the hedge effectiveness testing undertaken by MBS adequately or at all, failed to ensure that any such testing complied with IAS 39 and failed to identify that the testing undertaken by MBS did not comply with the requirements of IAS 39 and Mr Gee failed thereby to act in accordance with

Fundamental Principle 3 “Competence” and Fundamental Principle 4 “Performance” in the Guide to Professional Ethics and Fundamental Principle C “Professional Competence and Due Care” in the Code of Ethics and the ICAEW’s Guidance for Members in Business.

2.5 Mr Gee failed to adequately review the valuation of fixed rate products, failed to ensure that any such valuation complied with IAS 39 and failed to identify that the valuations undertaken by MBS did not comply with the requirements of IAS 39 and Mr Gee failed thereby to act in accordance with Fundamental Principle 3 “Competence” and Fundamental Principle 4 “Performance” in the Guide to Professional Ethics and Fundamental Principle C “Professional Competence and Due Care” in the Code of Ethics and the ICAEW’s Guidance for Members in Business.

**Particulars**

62. MBS did not comply with the requirements of IAS 39 between March 2006 and March 2013, and therefore was not entitled to use hedge accounting in FY06, FY07, FY08, FY09, FY10, FY11 and FY12. The final version of the FY12 financial statements did not incorporate hedge accounting.

63. The key areas in which MBS did not comply with IAS 39 were:

(1) Documentation.

(2) Designation.

(3) Retrospective effectiveness testing.

(4) Prospective effectiveness testing.

64. MBS failed to comply with the documentation requirements of IAS 39 as set out in paragraph 56 above and as set out in paragraphs 76 and 77 below.

65. The Policy formed an appendix to the MBS Financial Risk Management Policy. Following the provision of the Policy Advice no detailed reviews of the Policy took place by Grant Thornton as part of the 2006 and 2007 audits.

**Designation**

66. The Policy did not reflect the designation methodology adopted by MBS. The Policy states:

*"The hedge will be taken for a period, which will match against the fixed rate maturity profile of the portfolio of mortgages being hedged against"*

67. This is not what MBS did. The maturity profiles of the mortgages in many cases did not match the maturity profiles of the swaps, particularly in respect of the longer-term swaps.

68. Through the entire period of the application of the hedge accounting policy, MBS held swaps for which the maturity dates significantly exceeded the maturity dates of the mortgage products designated to that swap for hedge accounting purposes. IAS 39, and in particular IAS 39, paragraph 75, did not permit "part" designation of derivative instruments, and accordingly as the period of the swap beyond the maturity dates of the mortgages was unhedged, hedge accounting could not be applied for movements in the values of those mortgages.

69. MBS substituted and replaced mortgage products within existing swap designations on an ad hoc basis. This was not permitted under IAS 39. Changes to the designated mortgages would require hedge de-designation and re-designation. On de-designation the fair value adjustment should be frozen and an amortisation profile set up to match the remaining life of the hedged item. This was not done.

**Retrospective Effectiveness Testing**

70. The assessment of the fair value of a hedged item was commonly inconsistent with the hedged item's contractual terms and with its expected cash flows. The retrospective effectiveness tests assumed that the maturity dates and the interest payment dates of the mortgages matched those of the swaps. They did not match. As noted previously, the maturity dates of the mortgages were often shorter than that of the swaps which were used to hedge the interest rate obligations of those mortgages. These differences are likely to have created increased ineffectiveness had proper testing been applied. Moreover no interest was paid on the lifetime mortgages until the date of their redemption.

71. By assuming that the maturity dates and interest payments on the mortgages and swaps matched, the effectiveness tests carried out by MBS made the hedging look effective for IAS 39 purposes when it may not have been.

72. The designated mortgages were revalued by MBS as if they were Gilts. In the context of lifetime mortgages this process was inappropriate because lifetime mortgages had no periodic payments, in contrast to a Gilt. Rather in lifetime mortgages interest is rolled up into the mortgage balance. The fair value of an instrument which pays a cash interest coupon will be different from one where interest is rolled up even if all

the other terms match. Using the Quantum Gilt model would have been likely to produce incorrect valuations of lifetime mortgages.

73. The retrospective effectiveness testing did not taken into account any impairment which was likely to affect cash flows or the likelihood that mortgages would redeem prior to maturity. The effectiveness testing proceeded on the assumption that impairment and early redemption would not happen and this assumption was not tested.

74. The basis of retrospective effectiveness testing was based upon flawed assumptions. These assumptions had the inevitable effect of giving the impression of high levels of effectiveness because the assumptions created the false comparison of income streams with matching characteristics.

75. IAS 39, paragraph 75, provides that the hedging instrument must be designated for the entire life of the hedging instrument. Appendix 2 of the Policy gave an example of effectiveness testing, showing a comparison of fair value movements on the mortgages and swaps. This shows movements for only the past year. However, there was documentation indicating that in practice the effectiveness calculation was done on a cumulative basis, calculating movements for the entire hedge relationship. That methodology was inconsistent with the Policy.

**Prospective Effectiveness Testing**

76. IAS 39, and in particular IAS 39, paragraph 88, requires hedges to be prospectively tested to confirm that they are expected to remain highly effective. While the methodology of prospective testing is not prescribed, prospective effectiveness testing must be set out in the inception documentation and performed in accordance with that documentation. Such testing must be conducted, at a minimum, at each time the entity prepares its annual or interim financial statements.

77. The Policy does not set out any methods for prospective effectiveness testing. There was no documented evidence of prospective testing being undertaken. The requirements of IAS 39, paragraph 88 were never met.

78. Furthermore the effectiveness testing ought to have taken into account the impact of mortgage impairment and mortgage pre-payment, but did not do so.

**Summary**

79. By reason of the factors listed at paragraphs 56 to 77 above MBS did not comply with

IAS 39 for the period between March 2006 and March 2013 and the failures were clear, serious and substantial. Within MBS Mr Gee was primarily responsible for ensuring that MBS complied with IAS 39 and the preparation of the financial statements which stated that MBS complied with IAS 39.

80. The failures had a significant impact on the business of MBS as summarised at paragraphs 53 to 56 above.