24 August 2012

Mr Colin Lee
Parliamentary Commission on Banking Standards
House of Commons
London SW1A 0AA

Dear Mr Lee

ICAEW submission to the Parliamentary Commission on Banking Standards

Please find attached with this letter a submission to the Commission from the Institute of Chartered Accountants in England and Wales (ICAEW).

We would be happy to provide oral evidence to the Commission. Please contact my colleague Sarah Buckley, Public Affairs Manager, on +44 (0)20 7920 8614 or sarah.buckley@icaew.com if you would like to discuss our submission further.

Yours sincerely

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ICAEW RESPONSE TO THE PARLIAMENTARY COMMISSION ON BANKING STANDARDS

Submitted August 2012, in response to the Commission's call for evidence.

1. ICAEW welcomes the opportunity to provide evidence to the Parliamentary Commission on Banking Standards. We have extensive experience of professional standards and would be pleased to provide oral evidence to the Commission.

KEY POINTS AND RECOMMENDATIONS

2. **ICAEW strongly supports systems that support public confidence based upon professional standards**. We also recognise the challenges of operating such systems effectively.

3. **The UK should rearticulate its vision for effective principles-based regulation**. This vision has been lost, first by the distraction of promoting so-called 'light-touch' regulation, and then in the reaction against this approach. Effective principles-based regulation is demanding and should lead to better outcomes than alternative approaches.

4. **Regulation can crowd out professional standards**, with participants relying too heavily on regulatory compliance or not taking sufficient account of professional judgement or the principles that may lie behind regulatory objectives.

5. **The financial services sector should promote ethics and integrity at an organisational level**. Ethics and integrity are too often thought about as being matters for individuals. In addition to personal integrity, and the correct tone from the top, there is a need for an organisational structure that encourages and rewards people for acting with integrity, and which seeks to avoid creating conflicts among staff.

6. **Markets need market-based solutions, including self-regulatory measures.** This should not be in place of independent or government regulation, but should complement and go beyond this. Both individuals and banks should have affiliations with bodies that cut across organisations, promote high standards of professional behaviour and are prepared to lead and censure their members where appropriate.

REPONSES TO SPECIFIC QUESTIONS

Questions 1: To what extent are professional standards in UK banking absent or defective? How does this compare to (a) other leading markets (b) other professions and (c) the historic experience of the UK and its place in global markets?

7. The Commission should challenge the banking sector to develop an effective model of professional standards that supports and encourages personal and organisational integrity, is supported by effective monitoring and enforcement mechanisms and that can be seen to promote confidence. A sound and effective regulatory system will always be required, and should complement such a model. If the banks took professional standards seriously (and

could demonstrate that they did), government or independent regulation may become a backstop, rather than a primary means of maintaining confidence in the financial system. However, it may take a generation to achieve this objective of having professional standards in banking that inspire confidence.

8. ICAEW has a long history of applying professional standards. We are also aware of the challenges, tensions and issues that need to be addressed in such an approach. Codes of ethics are an important feature of a professional standards-based approach. Ethics and integrity involve an element of human judgement and, as such, are very hard to address through hard law, such as legislation or detailed regulation.

9. The financial services sector is, of course, heavily regulated, with a multitude of detailed rules rather than having an approach based on professional standards. The direction of travel has been to increase the extent, and amount of detail, contained in regulation, particularly in the face of too frequent problems, crises and scandals. Even when professional standards are proposed, they are often subsumed by rules-based regulation. For example, the FSA's Retail Distribution Review started by looking to replicate the professional standards-based model of the accountancy profession, initially proposing establishing an independent Professional Standards Board (PSB) to set standards but the final rules abandoned this approach with rules, rather than standards, set by the FSA in the same way as all other FSA regulations. This reversion to the regulator setting rules was presented as a development, rather than a change, in the FSA's proposals. This indicates a lack of understanding as to how to adopt a professional standards-based approach, as well as some potential discomfort about a more judgement based regime.

10. A potential unintended consequence of extensive rules-based regulation is that it can result in banks and individuals taking too much of a compliance approach to the way they conduct their business, and taking less responsibility themselves for their actions. Self-regulatory mechanisms, such as the need for responsible behaviour, can therefore become diluted. Banks can design their processes to take judgement away from individuals, instead building centralised decision-making processes to reduce the risk of individual error (as has happened with lending decisions). Individuals can then be tasked with operating within those frameworks and subject to approval from compliance departments.

11. When setting regulations it is important to consider the potential impact upon behaviour and the extent to which stronger regulations may undermine professional standards and self-regulatory structures. It is almost always in the long-term interests of banks and the banking sector to act with integrity, because the sector is based upon public confidence, and problems around confidence are very damaging, not only to individual institutions but to the sector as a whole. The long-term interests of banks and the banking sector, and those of the public interest and regulators, are closely aligned in terms of standards of behaviour.

12. However, short-term pressures can often lead to conflicts with these long-term goals. Self-regulatory mechanisms should focus upon addressing conflicts between short and long-term interest. Regulation, including professional standards, principles and rules, should seek to strengthen, rather than replace, self-regulation, including providing monitoring through supervision and sanctions. Regulation should also seek to address gaps in self-regulation and to take action where collective action is needed across the banking sector, but where it may not be possible for a bank to take unilateral action, for example because it would become significantly uncompetitive.

13. Self-regulation is often misunderstood and its importance under-estimated. We include among self-regulatory measures desirable features of any social group like integrity, self-discipline, adherence to norms of behaviour and peer-based enforcement of these norms. These features apply at both a personal and organisational level. The objective of increasing professional standards in banking should be to increase trust in banks and bankers. For such increased trust to be deserved, needs responsible people to behave in a responsible way. Self-regulatory measures can help to encourage and reinforce responsible behaviour. External regulation is also needed, not least because people do always not behave responsibly. However, even a regulatory system based upon highly prescriptive rules will not promote public confidence in banks if the underlying system is fundamentally corrupt and lacks self-discipline.

14. ICAEW's experience includes working with the World Bank on a number of capacity-building projects in developing nations. Developing a credible financial sector is seen as an important foundation for growth. Establishing professional bodies to raise professional standards is often one of the first steps towards developing this, particularly in the professions such as accountancy. We believe that a continued focus on professional standards is important, even when sophisticated regulation is in place, as both professional services and banking services are founded on trust and confidence.

15. There are a number of professional bodies in the UK working specifically in the financial sector, notably the Chartered Institute of Bankers in Scotland (CIOBS) and the Chartered Institute of Securities and Investment (CISI). Both these bodies provide specialist qualifications, set their own ethical codes and require members to undertake continuing professional development. We note that the former Chartered Institute of Bankers (the English and Welsh equivalent of CIOBS) changed its name in 2006 to the IFS School of Finance, to reflect a change in strategy towards being a business school for and about finance.

16. ICAEW has a well-developed code of ethics, and ethics are embedded within the training of all ICAEW chartered accountants. We also supplement this by providing a series of case studies and an ethics advisory helpline. The accountancy profession's approach to ethics is based upon 'threats and safeguards'. This recognises that ethical dilemmas and conflicts are inevitable, but that these can often be managed by adopting appropriate safeguards, which may include certain prohibitions. We believe that this approach, while potentially more difficult to apply as it requires judgement, leads to more ethical problem solving as it forces people to confront the ethical aspects of their behaviour.

17. The codes of ethics for financial services bodies tend to be set at a very high level. For example, the CISI and CIOBS codes of ethics set out in 8 and 9 principles. These bodies supplement this, for example through providing members with case studies setting out ethical dilemmas and running ethics training. It may be that their codes of ethics could be further developed and that their enforcement mechanisms and sanctions could be strengthened.

18. The accountancy profession has traditionally applied its ethical codes against both individuals and firms, with an ability to take disciplinary action against both. This ability is reinforced by our statutory responsibilities for licensing firms for audit, insolvency and undertaking investment business under the FSA Designated Professional Body regime. This link to organisations is important, because it extends ethical responsibilities beyond individuals. Being part of a wider constituency that cuts across organisations can be a powerful tool in promoting professional standards of expected behaviour.

19. Trade associations perform a different function to professional bodies. The financial services sector has a number of well-established trade associations, with the British Bankers' Association being the main banking body and the Association of Financial Markets in Europe the main investment banking body active in the UK, with a number of other, more specialist, bodies also focusing on particular areas, for example the International Swaps and Derivatives Association and Council of Mortgage Lenders. Their role focuses more on representing the interests of member firms. Working with member firms allows them to undertake cross industry initiatives to promote matters such as integrity, or reach agreed common treatments. They do not traditionally take on disciplinary functions against their members so their initiatives can lack bite, compared to those of professional bodies where disciplinary actions, potentially including exclusion, have real teeth.

Question 2: What have been the consequences of the above for (a) consumers, both retail and wholesale, and (b) the economy as a whole?

20. While regulations may be set to achieve better consumer outcomes, they often fail in that objective. There may be three reasons for this:

20.1. Banks may pay less attention to the substance of their actions, and take less responsibility for their behaviour, because they focus too much upon whether something complies with regulations.

20.2. Rather than protecting consumers, regulations may protect those subject to the regulation by creating safe-harbours and barriers to competition. Clear rules may also allow the industry to game the rules, to seek loop-holes or just push their business model more aggressively within the safe-harbour of the rules.

20.3. Consumers may over-rely on consumer protection regulation to protect themselves, and as a result pay insufficient attention to their own financial decisions.

21. In early 2007, ICAEW's Financial Services Faculty established a programme *Inspiring confidence in financial services* to examine issues around confidence. We identified four themes of responsible providers, responsible consumers, better regulation and better information. These four themes are heavily interconnected, and changes in one area can affect others, positively or negatively. The objective should be for solutions that encourage more responsibility from both the industry and consumers, that are supported by more effective and efficient regulation and clearer information.

Question 3: What have been the consequences of any problems identified in question 1 for public trust and in, and expectations of, the banking sector?

22. The financial crisis, continuing uncertainty over the soundness of the financial system and repeated scandals and problems in the sector have undoubtedly undermined public confidence both in banking and the wider financial sector. This is borne out by evidence from surveys, showing high levels of mistrust.

23. There are potential long-term consequences of this, not least with an ageing population and the challenge of ensuring that adequate post-retirement provision is made. Trust in the financial sector is important in encouraging people to save more for their future needs.

24. The financial sector also provides funding for the economy. A strong, trusted banking system is needed to support this. Even before the latest problems hit the front pages, our research[1] showed that the relationship between banks and many small and medium-sized businesses had broken down. Businesses, particularly smaller businesses, rely on banks for finance and other vital services, including advice. If such businesses are not able to trust the advice they receive from their banks, this is likely to damage the wider economy, particularly at a time when credit conditions are tough and businesses may need more advice.

Question 4: What caused any problems in banking standards identified in question 1?

25. There are a range of potential factors that could have affected banking standards. Many reports have examined the financial crisis and sought to attach blame to different areas, including the many areas highlighted in the Commission's call for evidence. One of the frustrations to policymakers seems to have been that it has been hard to do so, or find a smoking gun.

26. People generally adapt to the environment in which they operate. It would be wrong to characterise the problems as being about a small number of bad apples contaminating the whole sector. While undoubtedly this does happen, any well-developed sector should be able

[1] ICAEW SME Access to Finance Research Report, 2011

to cope with this type of problem without it causing too great a damage. The deeper question is why the financial services sector continues to run into problems which have been allowed to become pervasive.

27. Although a number of improvements have been made to areas such as regulation, corporate governance, internal controls, financial reporting and external audit, we do not believe they were a direct cause of any lack of banking standards. These are all areas where continual improvement is sought, and often new requirements are introduced in response to lessons from past problems. We have conducted our own research in particular into accounting standards and continually monitor the independent academic evidence on this, which is substantial, and have found no credible evidence that accounting standards contributed to the financial crisis in any substantial way. In fact, the evidence that has emerged points towards current accounting standards addressing issues more quickly and transparently than earlier standards.

28. However, in keeping with our analysis that regulations and standards can shift behaviour, it may be the case that tightening both regulations and standards may have subtly shifted behaviour from judgement towards compliance, to the extent that people have accepted with less questioning whether the answers given by their systems provide the right answer.

Question 5: What can and should be done to address any weaknesses identified? To what extent are such weaknesses subject to remedial corporate, regulatory or legislative action, domestically or internationally?

29. We propose three measures that can and should be taken to promote higher standards of professional behaviour in the banking, and wider financial services sector:

29.1. Ethics and integrity are multi-faceted concepts. More focus should be placed upon considering ethics and integrity at an organisational level. Ethics and integrity are too often thought about as being matters for individuals. ICAEW has carried out extensive work in these areas, with projects including *Reporting with integrity*, *Instilling integrity in organisations* and *Real integrity*. This work has found that sending individuals on ethics training can only go so far in promoting organisational integrity. In addition to personal integrity, and the correct tone from the top, there is a need for an organisational structure that encourages and rewards people for acting with integrity, and which seeks to avoid creating conflicts among staff, including through reward structures.

29.2. Self-regulatory measures should be actively sought. This should not be in place of independent or government regulation, but should complement and go beyond this. Both individuals and banks should have affiliations with bodies that cut across organisations, promote high standards of professional behaviour and are prepared to lead and censure their members where appropriate.

29.3. The UK should remember and rearticulate its model and vision for effective principles-based regulation. This vision has been lost, first by the distraction of promoting so-called ‘light-touch’ regulation, and then in the reaction against this approach.

30. We believe our last point is important. The UK approach of principles-based standards is the right approach for promoting responsible behaviour. This should not be equated with light-touch regulation. In fact, properly implemented principles-based regulation can be far more effective than a system based upon detailed rules as principles are far more capable of being applied to changing circumstances. To highlight this, although LIBOR was not regulated as such, the FSA was able to take enforcement action based upon breaches of its core principles.

31. Under a principles-based approach, participants are forced to consider not only whether the letter of the rules has been complied with, but also the spirit based upon underlying principles. Regulators must also be prepared to supervise behaviour according to their principles. Because there may be judgement involved, a principles-based approach may also require a different approach to enforcement, based upon professional judgement. This is the basis of our threats and safeguards approach to ethics mentioned above, and of our approach to enforcing professional standards. ICAEW has recently published a paper *Acting in the public interest: a framework for analysis* which, among other things, considers a variety of implementation and monitoring approaches, generally categorised as 'carrot, stick and sermon'. Professional bodies' approaches tend to be a combination of all three.

32. Principles-based approaches are also better at coping with changing situations. Drafting detailed rules can exacerbate problems of individuals gaming the system, with regulators having to continually adapt their rules to keep up with new innovation. Principles, if properly formulated, have a better chance of staying ahead of innovation, and coping with it.

33. We will be responding separately to the Wheatley Review into interest rate benchmark setting. However, as an example of our support for principles-based regulation, we would not favour introducing explicit offences of manipulating benchmark interest rates as we believe that the existing provisions of the Fraud Act cover these matters, in addition to the FSA's core principles. We believe that the Fraud Act is very well drafted, and would welcome case law to establish that it can cover such market manipulation. We would support extending the Market Abuse Directive so that it can cover issues such as LIBOR manipulation, but had it been drafted in a more principles-based way, the Directive may have already caught this.

Question 6: Are the changes already proposed by (a) the Government, (b) regulators and (c) the industry sufficient? Respondents may wish to refer to the Financial Services Bill and the Government's proposals for the Banking Reform Bill. They may also wish to refer to proposals by the Bank of England and the Financial Services Authority on how the Financial Policy Committee, Prudential Regulation Authority and Financial Conduct Authority will operate in practice.

34. Significant changes have been adopted, or are in the process of being adopted, both regulatory and non-regulatory. It is still too early to tell how effective they will be. This will only become apparent after it has been possible to assess how behaviour has changed, both positively and negatively.

Question 7: What other matters should the Commission take into account?

35. ICAEW supports the development of market solutions to issues, particularly where the industry works with regulators and all other stakeholders to develop them, and where the objective is to promote trust and confidence. Such solutions often do not need regulatory or legislative intervention and can be developed more quickly. In addition to our work on integrity mentioned above, ICAEW's Financial Services Faculty is undertaking a project *Market failures: market solutions* which aims to develop ideas for steps the banking sector can take to restore confidence.

36. ICAEW has developed its own market solutions to some of the challenges highlighted by the crisis. Our report *Audit of banks: lessons from the crisis* provided recommendations on actions auditors can take to improve their contribution in light of the crisis. This report followed up evidence ICAEW provided to the Treasury Committee and, subsequent to its publication, ICAEW has worked with the Bank of England and FSA to develop a code of practice for better communication between auditors and supervisors, issued guidance to improve dialogue between auditors and audit committees, established an auditor-investor forum to improve this dialogue and developed professional guidance for undertaking skilled persons' reports under the Financial Services & Markets Act 2000, working closely with the FSA in developing this guidance. We believe that each of these will promote confidence but none required formal legislation or regulation.

37. ICAEW has also just started a project to develop guidance for providing external assurance on banks' interest rate benchmark submissions, such as LIBOR. There is currently no general requirement for any such submissions to be audited, although Barclays, as part of their settlement with the Commodities and Futures Trading Commission (CFTC), has been specifically required to obtain external assurance. While the future processes for LIBOR are under review, we believe there may be a quick win for banks to be able to say they are voluntarily having their submissions reviewed, even in the absence of a regulatory requirement. We also believe that our guidance will add significant credibility to such assurance as it will be based upon international standards. We are committed to working with the FSA, CFTC and other interested parties in developing this guidance.

WHO WE ARE

38. ICAEW is a world-leading professional accountancy body. We operate under a Royal Charter, working in the public interest. ICAEW's regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the UK Financial Reporting Council. We provide leadership and practical support to over 138,000 member chartered accountants in more than 160 countries, working with governments, regulators and industry in order to ensure that the highest standards are maintained.

39. ICAEW members operate across a wide range of areas in business, practice and the public sector. They provide financial expertise and guidance based on the highest professional, technical and ethical standards. They are trained to provide clarity and apply rigour, and so help create long-term sustainable economic value.

40. The Financial Services Faculty was established in 2007 to become a world class centre for thought leadership on issues facing the financial services industry acting free from vested interest. It draws together professionals from across the financial services sector and from the 25,000 ICAEW members specialising in the sector and provides a range of services and provides a monthly newsletter FS Focus.

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