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THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES

16 June 2009

Our ref: ICAEW Rep 70/09

Your ref:

Financial Services Authority
25 The North Colonnade
Canary Wharf
London E14 5HS

By email: dp09_02@fsa.gov.uk

Dear Mr Cook

**DISCUSSION PAPER 09/2: A REGULATORY RESPONSE TO THE GLOBAL BANKING CRISIS**

The Institute of Chartered Accountants in England and Wales (the ICAEW) is pleased to respond to your request for comments on the *Discussion Paper 09/2: A Regulatory Response to the Global Banking Crisis (DP09/2).*

Our response was led by the Financial Services Faculty on behalf of the ICAEW, with significant input from other ICAEW Faculties and Committees, including the Financial Reporting Faculty, Company Law Committee, and Ethics Standards Committee.

Please contact me should you wish to discuss any of the points raised in the attached response.

Yours sincerely


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THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES

# ICAEW Representation

**ICAEW REP 70/09**

**DISCUSSION PAPER 09/2: A REGULATORY RESPONSE TO THE GLOBAL BANKING CRISIS**

**Memorandum of comment submitted in June 2009 by The Institute of Chartered Accountants in England and Wales, in response to the Financial Services Authority *Discussion Paper 09/2: A Regulatory Response to the Global Banking Crisis* published in March 2009.**




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## INTRODUCTION

1. The Institute of Chartered Accountants in England and Wales (the ICAEW) welcomes the opportunity to comment on the *Discussion Paper DP09/2 A Regulatory Response to the Global Banking Crisis* published by the Financial Services Authority.

## WHO WE ARE

2. The Institute operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, the Institute provides leadership and practical support to over 132,000 members in more than 165 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. The Institute is a founding member of the Global Accounting Alliance with over 775,000 members worldwide.

3. Our members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. The Institute ensures these skills are constantly developed, recognised and valued.

4. The ICAEW's Financial Services Faculty was established in 2007 to become a world class centre for thought leadership on issues and challenges facing the financial services industry, acting in the public interest and free from vested interests. It draws together professionals from across the financial services industry and from the 25,000 ICAEW members specialising in the sector.

## MAJOR POINTS

### Continued support for principles-based regulation

5. Principles based regulation should not be confused with light touch regulation. The ICAEW supports the policy of principles based regulation as it provides the basis for a more robust system, better able to cope with changing circumstances.

6. We understand that the FSA is still committed to principles-based regulation, but that it now feels it is simpler to express this concept in terms of the outcomes delivered by firms – ie that results matter more than the precise processes adopted. We also understand that the FSA believes that in some areas, notably with regard to prudential regulation, principles are not enough and need to be buttressed by some rules, not least because of the consequences of a bad outcome, such as insolvency. We have considerable sympathy with these points.

7. Some of the arguments towards moving to a more principles-based approach remain valid not least that such an approach deals better with changes in financial markets than a lengthy rulebook. We hope that points such as this will continue to guide the thinking of the FSA in the future.

**Operational effectiveness as important as system design**

8. We believe that current weaknesses in the regulatory structure have been in the operational area as well as the design and policy area. We agree with the FSA that there is a need to focus on the systemic issues, in addition to their focus on supervising individual banks.

9. Communication and coordination between the tri-partite authorities can be improved. The FSA, Bank of England and Treasury each had responsibilities for systemic risk, but there was insufficient clarity in the past over the interaction between their respective responsibilities.

**Reform of liquidity risk and prudential capital rules needed**

10. Reform of the regulation of liquidity risk management will be as important as reform to the capital adequacy framework. We also believe that a major review of what counts as capital is long overdue. It is highly desirable that international agreement is reached on the precise interpretation of what constitutes Tier 1 and to make the framework less complex.

11. We are surprised that the issue of the leverage ratio itself is not one for consultation. The case for such a ratio needs to be made more persuasively than described in *DP09/2*.

**Procyclical impacts of financial reporting unproven**

12. The relationship between financial reporting and the business cycle is complex and, in important respects, remains unclear. While it is theoretically possible that financial reporting contributes to some extent to cyclicality, we have seen no substantial evidence; what we have seen so far is slight and inconclusive. As far as we have been able to ascertain, there is thus at present no firm evidence that financial reporting either caused the current crisis or made it significantly worse.

13. It has been suggested that fair value information contributes to pro-cyclicality. Financial reporting necessarily reflects the business cycle. This means that in the good times firms will show higher profits and stronger balance sheets, and in the bad times they will show losses (or lower profits) and weaker balance sheets. Business decision making appears to be pro-cyclical, as good times fuel expansion and bad times can reinforce contraction. However, it is not clear whether it is the financial reporting results or the business cycle itself which influence this decision making. The available evidence and the Turner Report also indicate that transparency allows problems to come to light sooner, and therefore for remedial measures to be taken at an earlier stage. To this extent, financial reporting may in fact be countercyclical.

14. In our view, what is most important is to ensure that transparent financial reporting of the underlying reality is protected. In the absence of firm evidence on procyclicality, reducing the transparency of financial reporting risks substantial damage to the information available to investors without providing any corresponding benefits for either accounts users or the wider community.

**Objectives of financial reporting and prudential regulation are different**

15. Existing requirements within International Financial Reporting Standards (IFRS) for certain financial instruments to be measured according to fair value accounting are there for good reason and reflect the relative weakness of historical cost accounting, the main alternative, for these particular items. Transparent financial reporting will be a key requirement for rebuilding confidence in the financial services sector.

16. Prudential regulators should address the problem of procyclicality through the use of prudential filters and capital requirements. We do not believe that the introduction of counter-cyclical capital reserves or buffers in financial reporting will deliver the changes the FSA envisages in reducing procyclicality nor would it curb distributions and remuneration. If the aim is to require banks to hold more capital in case of a downturn, we believe that the more straightforward and transparent approach is to adjust the capital requirements.

17. The principal purpose of financial statements is to provide transparent information to shareholders and investors about the financial situation of the preparer entity. Reported earnings and EPS are investor metrics and we would not support these being shown before and after an Economic Cycle Reserves (ECR) movement as this risks substantial confusion in the market. We do not agree with any attempt by the FSA to allow banks to establish provisions that do not meet the definition of a liability and the IASB should be left to consider the extent of provisioning under its own rules and following due process. We believe that an ECR would not achieve anything substantive in practice, risks making financial statements appear confusing and less transparent and that focus on an ECR is a distraction from the causes of the crisis.

**Evolution, not revolution, needed in international audit firm supervision**

18. We are very conscious of the increasing internationalisation of audit firms and support the development of multi-disciplinary structures in a direction which promotes greater consistency of quality across borders. We also recognise that the development of international networks of professional services firms has an important regulatory dimension. There is a great deal of useful work which could be done to improve the operation of the existing supervisory framework short of the introduction of a new global architecture.

**Encourage improved dialogue between FSA and auditors**

19. We think more dialogue between the FSA, auditors and management on a wide range of information relevant to the regulation and audit of financial services firms should take place, not just in relation to the financial statements themselves. In recent submission to the Treasury Select Committee, we set out areas where the role of auditors could be extended to enhance confidence in information reported by banks.

20. There is a need to avoid a regulatory over-reaction on non audit services. This issue has been comprehensively reviewed post Enron, and subsequently. It will be more useful to work towards the adoption of the forthcoming revised IFAC Code of Ethics, which would apply to the larger audit firms globally. This would be a key building block in a global architecture for audit firms, which could not be achieved by the continuation of different ethical standards in each country.

## Effective, efficient international coordination is critical

21. The ICAEW supports a greater degree of regulatory consistency and coordination across the EU, provided it results in workable arrangements that address public interest needs without posing disproportionate compliance burdens on businesses and regulators.

22. The ICAEW believes that regulatory assessment of systemic risk should be coordinated at the global level. Methods of monitoring and co-ordinating the regulation of banks must be developed at an international level, due to the global nature of financial markets. Measures adopted in a single jurisdiction will not be sufficient to address the weaknesses in the regulatory framework as the risks are global.

23. We consider that there is a danger in seeking a profusion of international bodies to provide both macro-prudential supervision and oversight of national micro-prudential bodies, which could dilute the impact of each. We consider that the FSA should give its full support to the increased role on financial stability for the Financial Stability Board (FSB) in Basel and the Bank of England, working together with the new authorities at Lamfalussy Level 3 which were proposed by the De Larosière report and now endorsed by the European Commission.

## Other Comments

24. In this comment letter we are not responding to aspects of corporate governance as we will provide a separate response to the Walker Review.

25. The ICAEW will also respond, in a separate comment letter, to the European Commission proposals, Communication from the Commission 'European financial supervision'.

## RESPONSES TO SPECIFIC QUESTIONS/POINTS

## The role of inadequate capital and liquidity in causing instability

***Q1: Are there shortcomings in the international prudential framework not already identified in the DP that are relevant to the analysis?***

26. One area where it would be helpful for the FSA to clarify its thinking is over disclosure and transparency. The paper suggests that market discipline failed to operate adequately. But in the FSA's view, was this because too little information was disclosed, or alternatively that too little of it was read, or addressed the key issues that proved to be important? The policy implications of these alternative perceived shortcomings are very different.

27. We believe that market discipline still has an important part to play in supporting the regulatory process, particularly as those concerned learn the lessons of recent experience. Pillar 3 is still at an early stage, and disclosures were not made in the build up to the financial crisis. It would therefore be premature to come to conclusions as to the effectiveness of a mechanism that still has room for development. That said there is a balance to be struck between lengthier disclosure and a more focused approach on the key parameters.

28. Separately, the FSA needs to be clear on how far it believes that public disclosure may exacerbate a crisis, and how far it can help to dispel it – either by showing the (limited) extent of the issue, or through encouraging firms to run themselves more prudently beforehand since they know there is no prospect of disguising the outcome. There have been some mixed signals on these points from the UK authorities over the past two years.

29. The FSA needs to say more on these issues, since if it feels that market discipline is ineffective, and disclosure exacerbates panic, the policy implications are markedly different than if – as has typically previously been assumed – the reverse is the case.

***Q2: What are the measures supervisors should take to mitigate the risks to depositors and other unsecured senior creditors of secured funding, taking account of the benefits of such funding where used to an appropriate degree?***

30. We have provided input into earlier FSA consultations on the special resolution regime for failing banks and on reforming the depositor protection scheme. We have no further comments at this stage.

**Solutions through micro-prudential measures**

***Q3: Do you agree with the proposals to redefine what counts as capital with a stronger emphasis on going concern loss absorbency?***

31. We agree that such a review is long overdue. It should focus on four things
- The purpose of capital
- The boundary issues between the different tiers of capital
- Deduction policies and practices
- The amount of capital required

32. The focus on going concern loss absorbency is appropriate for 'systemic' firms, who should be required to monitor their positions against Core Tier 1 and Tier 1 measures and demonstrate that their capital is 'fit-for-purpose' as a going concern. But as the FSA recognises, in other cases - eg non-banks, or smaller firms - it may be more acceptable for firms to fail, so long as customers and counterparties are protected. In other words, for non-systemic firms, and/or ones where continuity of service is less important, 'gone' concern capital may still have a role to play in ensuring that the claims of third parties are met, but with some time lag.

33. We agree that Tier 1 capital for any firm must have an undoubted capacity to absorb loss on a going concern basis. There will inevitably now be a degree of scepticism about any highly innovative instrument that purports to do this. As such, it is highly desirable that international agreement is reached on the precise interpretation of what constitutes Tier 1, taking into account the different structural features (such as tax) in each jurisdiction.

34. More generally, there is room for making the system less complex – eg by removing the distinction between what constitutes Tier 2 and 3 capital, and by looking again at the policy on deductions.

35. Markets – and indeed accounts – react to events faster than when the original Basel 1 package was drawn up. As such, the capital base is potentially now

more volatile, supporting the case for an increase in the 8% floor for total capital. But that figure was chosen in the 1980s without significant prior analysis. It is therefore important not to rush to decisions, but instead to instigate a fundamental (but not prolonged) review. The proposed move to 4% and 8% of RWA (for core Tier 1 and Tier 1 respectively) needs to balance the need to ensure capital is sufficient to absorb loss against the risk that too high a level will damage the commercial viability of banking, and the economy more generally, unnecessarily.

***Q4: Should IRB banks be required to use a system such as variable scalars, or equivalent, whose effect is to limit the potential for procyclicality in capital requirements to a level that would be produced by a [through the cycle (TTC)] ratings system?***

36. We agree with this point in theory, but would emphasise the practical and technical difficulties involved.

37. Working out the level of capital implied by a TTC system is far from easy, given the complexities of distinguishing changes in loan loss experience due to cyclical factors from those that reflect structural effects. However, if one could do this, and knew what results were implied by a TTC ratings system, it would be simpler to mandate its use directly, rather than trying to get the same result by tweaking the point-in-time approach. As such, variable scalars represent an imperfect, if pragmatic, solution to the issue.

***Q5: Are there any other key issues that the review of trading book capital should cover?***

38. We believe that there are several issues here.

39. First, while we accept that “liquid” markets are not always self-correcting, or indeed liquid, we do not feel they are necessarily more prone to irrationality than illiquid markets, notably housing. In our view some of the recent problems may have stemmed from allowing into the trading book complex, illiquid, and credit-intensive products. VaR models were never going to deal with these as well as they dealt with eg FX risk.

40. Second, the proposals should focus not just on the numerical aspects of trading book risk and capital assessment, but also on some important, softer aspects (eg desk ‘leadership’ and integrity, rewards, impact of risk management team/internal audit team reviews etc).

41. Third, there are particular problems in measuring credit risk given the long cycles involved (interest rate and FX volatility vary too, but typically over shorter time periods). As such it may be acceptable conceptually to put some floor – whether via incremental risk charges, stressed VaR or a standardised charge – on the results of the VaR modelling of credit positions. However, the practicalities of doing so need to be looked at further. We note that when the Basel II market risk package was first agreed, just such a floor was temporarily put on the modelled specific risk charge.

42. Finally, those of us who have worked extensively on ‘standardised’ approaches to market risk are conscious of the problems with such rules for hedged positions. The resulting regime tends to be both complex and inaccurate (eg a hedge may be allowed to offset 100% of the risk, or none, or a sliding scale

may be applied, which for a book with thousands of positions is immensely clumsy). As such we believe that VaR in some form still has an important part to play in assessing the risk on a large-scale book. We are also doubtful whether 'stress testing' is the complete answer, unless the stress is specified in so much detail that it is in effect a complex standardised approach.

43. In brief, therefore, we accept that there may be a role for regulators in setting floors below which the modelled risk on an outright position cannot fall, however benign the macroeconomic backdrop, but do not believe that such an approach can be used easily for a large book in which many of the positions are partially hedged.

***Q6: How should the leverage ratio capture (i) off-balance sheet exposures and (ii) derivatives?***

44. In our response to the International Accounting Standard Board (IASB) on ED 10 relating to consolidation, we agreed with the standard setter that reputational risk was insufficient to bring a potential exposure on balance sheet and we continue to be of this view in that the resulting financial statements, with some additional disclosures in relation to such exposures, produce the most transparent information for investors.

45. So far as derivatives are concerned, prudential regulators can take into account such exposures by following the existing regulatory rules that define the credit-equivalent amount. In doing this, we assume that regulators will also look to adjust these rules to include all items which the firm would bring back on to the balance sheet for reputational reasons. This has the advantage of being entirely within the control of regulators rather than accounting standard-setters, whose role is to ensure that accounts serve investors and other stakeholders.

46. Though there are real difficulties in determining what actions would be taken to protect reputation or for commercial reasons, i.e. where the returns are suitable compensation for the risk. A bank would have to weigh up the costs of stepping in against the potential reputational costs of not doing so and then act in its best interests in the circumstances at the time, which cannot easily be predicted in advance. Is it possible to distinguish 'reputational reasons' adequately for regulatory reporting or would it mean that nothing ever achieved derecognition/non-consolidation for regulatory purposes just in case?

47. For international comparisons, there are additional issues raised by differing treatments of netting, and consolidation, between IFRS and US GAAP, which is a further argument for a regulatory rather than accounting solution.

***Q7: Should the numerator of the leverage ratio be Core Tier 1 capital or should a broader measure of capital be used?***

48. We refer you to our answer to Q3: core Tier 1 might be an appropriate metric for a large bank but it is less clearly appropriate for other firms.

49. We are surprised that the issue of the leverage ratio itself is not one for consultation: the case for such a ratio needs to be made more persuasively than in this paper. Basel 1 was a reaction to the problems with a non-risk-weighted measure that focused purely on the balance-sheet. While the US retained it as a secondary measure, as part of its Prompt Corrective Action regime, the performance of US banks in the recent crisis suggests it is not a

panacea, Canadian banks, also subject to such a regime, fared better (though it is clear that other factors influenced their situation).

50. It is our understanding that the intention is for the ratio to be a backstop - ie not normally to 'bite', and be calibrated accordingly. This seems sensible.

51. But the case for having such a ratio must rest on one of three propositions. Either

- The capital requirement of an outright position typically falls too far in a boom, as measured risk declines. If so, this is arguably best tackled at source – eg via stressed VaR calculations – and not via a leverage ratio.
- The capital requirement of a hedged position is (mis)calculated at zero, or at far too low a level, despite there being significant basis risk in some circumstances eg if the price of the underlying moves a long way. As a result the balance-sheet expands by more than if risk had been measured more accurately. This is a potential concern, though it could be tackled at source by taking a more intrusive approach on how positions are mapped across into risk buckets. This is not easy, and it is possible that a leverage ratio could be a second-best solution, though the point requires further analysis.
- A large balance-sheet brings with it funding issues, even if the assets are of high-quality and can be used as collateral. This does not apply to the same extent to smaller, but high-risk balance-sheets. This is an empirical matter, which should be capable of being demonstrated.

52. Although a leverage ratio is an attempt to address the 'time series' issue – ie that modelled risk may fall too far in an upturn – it does not address the 'cross-section' issue: it does not bite on a firm that sells low-risk assets and moves into higher-risk products (ie chases yield) but just to one that expands its book across the board. We rather doubt whether this is a desirable property for a capital rule.

**Macro-prudential policy**

***Q8: Should these reforms be applied to smaller and domestic banks, building societies and investment firms? If so, how can this be achieved in a proportionate manner?***

53. The underlying principle should be that these reforms apply to the smaller institutions – recent cases involving certain building societies demonstrates that need – and should significantly restrict any tendency to move into financial exotica or areas that are not very clearly understood by management and the Directors/Board. These smaller sectors might also put forward alternative approaches (for example, simplified models) that might address the major macro-prudential challenges the FSA is seeking to address – this would allow for a more proportionate set of regulatory requirements.

54. However there must be mechanisms to allow new businesses to be established or new lines of business to be opened up without unnecessarily stifling any reasonable entrepreneurial activity. The use of temporary exemptions and/or waivers could assist this although this will create tensions for both existing players and the regulatory bodies themselves. An interesting alternative might be the creation of a specific team within the regulator whose remit is to oversee such businesses/propositions – with a clearly defined modus operandi this

could allow new ideas/propositions to come to fruition and develop but within a clear and ever-present tiered regulatory framework.

***Q9: Do you agree with the FSA's reasons for favouring a range of policy measures to deal with macro-prudential policy issues rather than adjusting the Basel II risk-based capital requirement?***

55. We agree.

***Q10: What should be the focus of the FSA's initiatives on valuation and disclosure in UK banks' accounts so as to maximise their impact on market confidence?***

56. Financial statements are not primarily designed to give the market confidence in the sense intended by the FSA. The 'market' referred to by the FSA is presumably meant here as all markets in which banks transact, meaning the whole financial system. It does not mean the market for equity investments for banks, the servicing of which is the purpose of banks' financial statements. This is in our view the heart of a 'different purposes' problem in relation to financial statements that the FSA report fails to recognise, even though it is highlighted in the Turner Review. Financial statements are there to help capital providers, particularly equity investors, make capital allocation and stewardship decisions in relation to individual financial institutions. They are not there to act as a tool for prudential regulators to promote market confidence in the manner suggested by the FSA.

57. There are other important issues to be considered if the FSA believes it should be involved in valuation issues as proposed. We support the use of a principles-based framework for financial reporting. In such a framework management judgement is essential and will not always lead to identical outcomes for different businesses. To the extent that differences in valuation techniques are the result of underlying differences in economic circumstances, we do not regard the pursuit of uniformity as a useful goal. That said, dialogue between the FSA, management and auditors may serve useful purposes in identifying unnecessary inconsistencies in valuation approaches and helping the market to understand where uniformity is not desirable. We would be very concerned if the FSA - whose focus is on financial staibility not investor information - were to extend its role into the interpretation and application of financial reporting standards. This is an area which is firmly within the remit of accounting standard-setters (the International Accounting Standard Board (IASB)) and, for interpretations, (the International Financial Reporting Interpretations Committee (IFRIC)) and those charged with regulation of financial statements, such as the Financial Reporting Review Panel. The FSA should consult with industry as to how such a process would work in terms of resources, timing, application of the memorandum of understanding with the UK Financial Reporting Council (FRC) and resolution of differences of opinion. The FSA also needs to consider how a more interventionist approach sits with the heavy legal onus on directors in taking responsibility for the financial statements.

58. This does not mean that the content of the financial statements should never be the part of the FSA's focus. For example, we think more dialogue between the FSA, auditors and management on a wide range of information relevant to the regulation and audit of financial services firms should take place, not just in relation to the financial statements themselves. In recent submission to the

Treasury Select Committee, we set out five areas where the role of auditors could be extended to enhance confidence in financial reporting:

a. Financial information outside the accounts
b. ‘Pillar 3’ risk disclosures
c. Regulatory returns to the FSA
d. Control activities chosen by the FSA
e. Bank-specific meetings with the FSA

59. The aim of these proposals is to contribute to enhanced market confidence in banks by increasing trust in the information that banks report to the public and to the regulator. Currently, auditors focus on banks’ financial statements only (subject to checking consistency of other material within the annual report) and report to the shareholders. There is scope for assurance work to be performed on information being reported to the regulator by banks. The detail of our proposals is set out in the Appendix [*Ideas for enhancing confidence in banking reporting*] of this response (see separate attachment).

60. The FSA raises the possibility of introducing mandatory enhanced disclosures for banks. We note that the IASB has recently introduced new disclosures into International Financial Reporting Standard (IFRS) 7 *Financial Instruments: Disclosures* which are not yet effective and also that it is undertaking a review of IFRS 7. In addition, Committee of European Banking Supervisors (CEBS) currently has disclosures under review. Given these initiatives, and the FRC’s project to reduce complexity in financial reporting, we would not wish to see the FSA acting unilaterally in this area, as this may lead to duplication and ineffective regulation. It would be more fruitful at this stage for the FSA to ask analysts what they find useful now and what more they would wish to see, although we hope and expect the IASB and CEBS initiatives in this area are already designed to satisfy such needs and will succeed in doing so.

61. Key users of bank financial statements, such as other banks, analysts and rating agencies, are very international in their approach and we consider therefore that adequacy of disclosures are best looked at in a Pillar 3 context. If the FSA considers that Pillar 3 requirements are insufficient, then they should lobby for improvement in those to deliver benefits across a much wider geography. Financial stability in the UK is dependent on institutions both within and outside the UK; specific requirements for UK banks would have very limited impact in comparison to high quality Pillar 3 requirements.

***Q11: Do you agree with the FSA’s analysis of the implications of accounting standards for procyclicality?***

62. The DP concludes that ‘It is likely that the mixed attribute model of accounting – especially the use of fair value embodied in it – has a procyclical impact, as in practice fair value is applied to a higher proportion of assets than liabilities’. It also notes that ‘Many commentators see ‘cost less impairment’ [or recoverable historical cost] – as currently implemented – as also being procyclical, and possibly as having contributed to the current financial crisis.’ The DP expresses neither agreement nor disagreement with this latter view, so we assume that the FSA is agnostic on it.

63. In our view, the relationship between financial reporting and the business cycle is a complex one and, in important respects, remains unclear. While it is theoretically possible that financial reporting contributes to some extent to cyclicality, we have seen no substantial evidence that this is so; what we have

seen so far is slight and inconclusive. As far as we have been able to ascertain, there is thus at present no firm evidence that financial reporting either caused the current crisis or made it significantly worse.

64. Nor do we think that a properly evidence-based answer to this question would be a black-and-white solution. Contributions to the debate on whether financial reporting is procyclical currently tend to advocate conclusions along the lines of 'Yes it is' or 'No it isn't'. We suspect that a more sophisticated analysis may well show some respects in which it could be procyclical and some respects in which it could be countercyclical. It will also be important to establish the degree – if any – to which financial reporting is procyclical. Is the suggestion that financial reporting contributed 0.1% or 1% or 10% to the business cycle? Clearly the extent of the contribution, if any, is central to any serious discussion of this issue, yet we have seen no attempt at quantification. This is probably symptomatic of the lack of hard data.

65. We certainly do not see that there is sufficient evidence to support the FSA's analysis of the implications of accounting standards for procyclicality. And there are important arguments against the DP's conclusions (see below). The DP may well, therefore, overstate the role played by accounting standards and financial reporting in the context of financial stability and, in so doing, understate the impact of more important drivers of financial stability, which should be the focus of attention.

66. The users of financial reports quite rightly expect them to reflect economic reality. However, in an economy subject to business cycles, reflecting reality means that in the good times firms will show higher profits and stronger balance sheets, and in the bad times they will show losses (or lower profits) and weaker balance sheets. This will be the case whatever the basis of measurement – eg, fair value or historical cost or a mixture of the two. To the extent that financial reporting information influences decisions, it is therefore possible that in the good times it will reinforce the tendency to expansion, while in the bad times it will reinforce the tendency to contraction. So it could be argued that financial reporting is by its very nature procyclical – simply because it reflects economic events as they occur.

67. It is also theoretically possible that:

- one basis of measurement; or
- one particular mixture of bases of measurements; or
- one way in which a particular basis of measurement is applied

is more procyclical than another. However, as noted above, the actual evidence on these points is both slight and inconclusive. The most substantial study of these issues, the SEC's *Study on Mark-to-Market Accounting* published in December 2008 concludes:

> 'bank failures in the US appeared to be the result of growing probable credit losses, concerns about asset quality, and, in certain cases, eroding lender and investor confidence. For the failed banks that did recognize sizable fair value losses, it does not appear that the reporting of these losses was the reason the bank failed.'

It is also possible that financial reporting is, in certain respects, countercyclical. The *Turner Review* comments:

> ‘And the evidence of the crisis suggests that the institutions which most rigorously applied mark-to-market [fair value] approaches, identifying rapidly the impact of falling liquidity and falling prices, performed best since they exited problem areas faster and at lower eventual cost.’

68. This seems to accord with common sense. Where financial reporting best reflects economic reality, it should also provide the best basis for responding realistically to changing circumstances, including changes in the business cycle, thereby minimising their adverse effects. We would not expect to see a conflict between good financial reporting and sound business decisions, such as would be compatible with minimising the risks of financial instability. Indeed (and as the *Turner Review* suggests), in the current crisis fair value information may have contributed in a positive way to getting the bad news out faster, which will have aided the clean up process.

69. There is also a need to be realistic about how far financial reporting information does in fact influence business decisions. The poor lending (and ill-advised borrowing) that sparked the current crisis was based on misplaced optimism about future economic growth and future asset values. It was not based on historical financial reporting. In this respect, businesses and individuals behave in the same way. It is not necessary for an individual to have seen the current value of his house on a published balance sheet, increasing year after year, in order to decide (erroneously) to borrow excessively against that value, in the hope that it will continue to increase in future. We think that the same applies to companies and banks. Blaming financial reporting in this context is simply shooting the messenger.

70. In spite of its analysis of the implications of accounting standards for procyclicality, the DP does not propose any changes to existing standards in order to avoid procyclicality. Instead, its approach is to allow financial reporting to serve users’ needs, but to filter out any procyclical effects for prudential and financial stability purposes. However, the DP’s claims on procyclicality may well influence others to call for reform of accounting standards. We must therefore reiterate that these claims are as yet unsubstantiated. Further research in this area is necessary so that evidence is available to support considered policy development. Requiring changes to financial statements without such evidence risks damaging the information available for investors without producing any corresponding benefits either for investors or the wider community. At this stage, focussing on the financial statements is a distraction from the real and acknowledged regulatory failings in the current crisis. Even if there were relevant evidence on the procyclicality of financial reporting, that does not mean the financial statements should be altered as that would mean they did not show a true and fair view; instead, the prudential regulator can mitigate the impact through prudential filters.

***Q12: How best should prudential regulators address the problem of procyclicality through counter-cyclical reserves/buffers?***

71. As noted above prudential regulators should address the problem of procyclicality through the use of prudential filters and capital requirements. We recommend that requirements around regulatory capital for banks be changed (see our response to *question 3-7*, above).

72. We do not believe that the introduction of counter-cyclical capital reserves or buffers will deliver the changes the FSA envisages in reducing procyclicality nor

would it curb distributions and remuneration. If the aim is to require banks to hold more capital in case of a down turn, we believe that the more straight forward and transparent approach is to adjust the capital requirements. We are unhappy with the proposals which risk undermining transparency in financial reporting and raise considerable practical difficulties which could give rise to unintended consequences. We outline our objections and our doubts about the effectiveness of such an approach below.

**Purpose of financial statements and the role of the standard-setter**

73. As already noted in our response the principal purpose of financial statements is to provide transparent information to shareholders and investors about the financial situation of the preparer entity. Whilst financial statements are used for a range of other purposes, such as taxation, remuneration decisions and prudential purposes, it is more appropriate for users to make the adjustments they require for those purposes rather than to include such distracting information in the primary financial statements. In the context of the FSA's proposals, the needs of prudential regulation should not muddy the waters for investors by changing key metrics in relation to net income and net assets. That said, we believe that banks' overall capital requirements and the contraints they create on banks' ability to make financial and operating decisions should be fully disclosed as information in addition to the general purpose financial statements, as shareholders would rightly have an interest in such information.

74. We support an international framework for financial reporting, with a single standard setter following proper due process. This enables standards to be developed which are principles-based and consistent. This role rests solely with the IASB, and interpretation of the standards falls solely to IFRIC. The ad-hoc, incremental introduction of changes to the primary financial statements by the FSA would run counter to the G20 support for international financial reporting standards. In this context, we are particularly concerned at the proposals for either some form of dynamic provisioning or ECR or Economic Cycle Provisioning. Although the FSA appears to favour an approach in which an ECR would only affect reserves, it is worth reiterating the problems with other approaches that are suggested in both the *Turner review* and the FSA DP:
    - Creating a provision as a liability that does not meet the definition of a liability is certainly not compliant with IFRS.
    - Creating an additional loan loss reserve as a valuation adjustment to the loan asset is probably not IFRS compliant as it seems incompatible with the incurred loss approach. Whilst the IASB is currently reviewing impairment and is considering approaches based on expected loss as well incurred loss models, its current incurred loss approach was based on thoughtful deliberations (see *IAS 39, BC108-110*). We will contribute to the IASB and FASB work in this area and respond to their due process in relation to proposed changes, the deliberations on which are already well underway.

75. Creating a separate reserve as an appropriation of the profit and loss reserve is unrelated to financial reporting,and hence would have a reduced impact on the financial statements in terms of investor information, but it has operational issues in terms of capital and reserve management, discussed further below. Better and more comprehensive disclosure of the overall regulatory capital of banks would, in our view, be consistent with the aim of transparency.

76. Furthermore, we believe any attempt to require new measures of Profit and Loss and Earnings per Share (EPS) before and after the ECR movement will undermine, rather than enhance, confidence in financial reporting by banks, even if the ECR were just shown as a reserve movement in the primary financial statements. These key metrics are provided for investors and any attempt to require such non-GAAP items, with some kind of official imprimatur over them, is likely to lead to confusion in the markets. Our answers to *questions 37 and 38* below set out some of the problems encountered by insurers when they made provisions similiar to those being proposed by the FSA for banks. The experience of insurers also illustrates how provisioning can undermine transparency.

77. The following accounting policy note is from CGNU plc 2000 year end financial statements (now known as Aviva) :

> ‘Provision is made in the Group accounts for the equalisation provisions established, where required, in the accounts of individual insurance companies in the United Kingdom and in a limited number of countries overseas. The provision is required by law even though no actual liability exists at the balance sheet date.’

78. The audit report in the CGNU’s 2000 year end financial statements included a reference on the provisions and an additional accounting policy note was also needed in CGNU’s financial statements to address the requirement for equalisation provisions.

79. In calculating an ECR, it is unlikely to be clear to regulators or preparers exactly where in the economic cycle they are, so the timing and amount of releases will be arbitrary. This is particularly the case the less sensitive the ECR is to a bank’s specific assets and risk profile and the more it is formula driven and sensitive only to general economic conditions. We query whether the ECR in the context of loan losses would in fact contain any informational content for the analysts following bank financial statements. This does not mean that counter-cyclical reserving is always ineffective, but rather that its effects should properly be imposed only through prudential filters and only in that context should its effectiveness be considered.

**Accounting for ECR**

80. We do not agree with any attempt by the FSA to allow banks to establish provisions that do not meet the definition of a liability and the IASB should be left to consider the extent of provisioning under its own rules and following due process. In relation to the Banco de España's system of dynamic provisioning, the assertion that their system has helped to strengthen Spanish banks may be an oversimplification. The most significant losses that were reported by banking institutions originate from downward valuations on assets (such as ABS) which are largely measured at fair value. The buffering effect of a provisioning regime as that prescribed for Spanish banks would have had only a limited impact (it only affects asset that are measured at amortised cost). The Banco de España's other prudential measures (eg preventing Spanish banks from dealing in certain asset classes) appear to have been more relevant in sheltering Spanish banks from the worst of the losses that affected its other European counterparts. Additionally, the counter-cyclicality of a dynamic provision is limited to the extent that banks would be able to record lower loan loss provisions and hence a higher profit or lower loss as a result of an

economic downturn. Ultimately, it will be the quality of assets and a bank's ability to use those assets to raise funding, that will enable a bank to weather a crisis without regulatory support. It may therefore be premature to consider the Spanish model as a means to prevent a future banking crisis. Spanish banks, in particular Spanish cajas, which lent heavily into the Spanish property bubble, may experience the effects of poor quality assets in the near future, despite the Banco de Espana's provisioning model. We therefore believe the focus of prudential regulation should not be provisions but the the quality of banks' assets. Provisions for loan losses should remain an accounting measure and be subject to accounting standards.

81. Reported earnings and EPS are investor metrics and we would not support these being shown before and after an ECR movement as this risks substantial confusion in the market. Establishing an ECR only as a movement on reserves would not fall foul of the GAAP rules (as most reserves are driven by statute) and so this approach would be the least likely to cause a loss of transparency. However, we do not believe there is evidence to suggest an ECR would achieve anything substantive in practice. Focussing on the presentation of an ECR in the financial statements is a distraction away from the required regulatory response to the crisis.

82. We believe instead that the one issue in relation to financial reporting that the prudential regulators should consider is to address whether the disclosure regime in relation to regulatory capital and reserves should be strengthened. This is a task for prudential regulators, not the IASB; if the IASB tried to introduce rules on disclosure of such information, it would be unlikely to do so in a way that all national prudential regulators would find satisfactory. We draw attention to the fact that *IAS 1* does not require disclosure of any externally imposed capital requirements whether industry-wide or entity-specific. The IASB noted that disclosure of the existence and level of entity-specific capital requirements is important for users because it informs them about the risk assessment of the regulator but decided not to impose such a requirement for a variety of reasons, including that such a disclosure requirement was not part of Pillar 3. If the FSA now believe that transparency of a bank’s regulatory capital position is consistent with their regulatory objectives, then we would support this disclosure but only if it is complete. Disclosure of one element only of entity-specific capital requirements, such as an ECR, is misleading as the information is incomplete. If the FSA wants banks to hold more capital, be it in the form of actual capital or set-aside reserves, then it should require banks to do so directly. And if the FSA believes that disclosure of such information is important from a market stability perspective, it should discuss disclosure bilaterally with the banks it regulates and lobby internationally for improvements to Pillar 3 disclosures, which may include introducing an audit requirement.

**Counter-cyclical reserves and distributions**

83. The determination of distributable profits is a complex area of accounting and law, for which we have developed comprehensive guidance, in the form of *Technical Release 01/08, Guidance on the Determination of Realised Profits and Losses in the Context of Distributions Under the Companies Act*. The *Turner Review* and the accompanying DP oversimplify the relationship between distributable profits and the use of fair values and financial reporting generally, with the result that the proposals around reserves are unlikely to curb dividends or buybacks in the manner intended. In particular, reported profits and EPS do

not reflect or equate to distributable profits, as the *Turner Review* and *DP09/2* infer.

84. Firstly, recognising a profit on a fair value uplift is not realised or distributable if it arises from an instrument that is not 'readliy convertible into cash' (see *paragraphs 4.2 and 4.3 of Tech 01/08*). There are also restrictions on when gains on own debt may be treated as realised, particularly where a company is in financial difficulty (see *paragraphs 4.14 and 4.15 of Tech 01/08*). This does not mean that the profits as recorded in the financial statements are 'illusory' as suggested by Lord Turner. These profits are real in that they have economic meaning, but they are not necessarily realised for legal distribution purposes. Furthermore, even when mark-to-market profits are legally realised (where they arise on highly liquid instruments readily convertible into cash), subsequent losses will reduce such profits (as opposed to reversing them), whether arising from falls in value of that instrument or any other loss. That is the nature of fungible profits. Again, subsequent losses do not make past profits 'illusory'.

85. Secondly, it is not clear from the DP whether it intends to focus on group financial statements or those of individual companies. Distributions are made by individual legal entities, rather than at a group level. This means that changes to reserves introduced at a group level - if this is what the FSA is considering - would have no effect on distributable profits available within the subsidiary or holding companies, and hence no effect on the level of distributions which could be made. It is also not clear how the proposals would operate for banks with different capital structures, for example, those with more share capital/share premium than reserves or those that tend to issue bonus shares out of reserves.

86. Yet even if the FSA does introduce changes at the level of individual parent and subsidary companies, dividend capacity depends on liquidity and capital needs of a bank and these typically become the biting constraints for banks rather than distributable profits availability. It is not therefore clear why any additional deductions from distributable profits would be of benefit. In practice it would merely result in capital reconstructions (and there are many tried and tested methods in the market) to overcome constraints where a bank has the resources to make dividend payments. If the changes were effected at the subsidiary level, there could also be adverse and unintended consequences for banks' ability to manage capital within the group. It is also not clear how the proposals would operate for banks with different capital structures, for example, those that, as a matter of policy, hold more of their shareholders' funds as share capital/share premium than distributable reserves or those that tend to issue bonus shares out of reserves. It would surely be an unintended consequence if the advent of an ECR reserve that did affect distributable profits caused some banks to switch sums out of share capital/share premium and into distributable reserves.

87. This approach to reserving would need to work internationally to be effective. However, the rules around distributions vary across jurisdictions, so proposals to reduce distributable reserves by reference to changes to reserving in the financial statements will not work in those countries in which distributions are not made by reference to the financial statements (for example where they are made on a solvency basis). The rules would not be applicable to UK branches of overseas banks nor to overseas branches of UK banks. The alternative which we propose - the increased use of prudential filters - will be easier to apply consistently in different countries.

88. The impact of disclosing a reduction in distributable reserves on the market is highly debatable. There is no existing requirement for the disclosure of distributable reserves and if there were market demand for such information, companies would presumably disclose it, rather than merely signalling dividend and buy back policies. Even if such disclosure was required or demanded by the market, many companies would find it very costly to apply all of what are now very detailed and complex rules in *Tech 01/08* in order to be able to state specifically what was distributable at any point in time. Their usual practice is to ensure they have sufficient headroom of surplus distributable reserves in order to make a distribution.

**ECR and remuneration**

89. One of the reasons put forward in the *Turner Review* for an ECR which goes through the profit and loss account, rather than just being a movement on the balance sheet, is that 'Incentive-based pay systems which refer to profit and EPS would then be based on distributable profit and distributable EPS'. This again oversimplifies how financial statements are used in practice and we believe that the approach is likely to prove ineffectual.

90. Adjustments to the financial statements for the purposes of calculating remuneration are routinely made, and it would thus be possible to remove the effect of the ECR. Indeed, frequently the calculation may be based on a profit number much higher up the statement or in relation only to a particular segment, thus negating the impact of the ECR. However, it is within regulators' remit to regulate remuneration more directly if this is considered desirable, which would be much more effective in practice, particularly as regards delaying payouts, so as to relate the payouts to the outcome of risks taken. As with prudential filters, a reported earnings figure could be a starting point, but with various adjustments required, including possibly an ECR-type adjustment (or a cost of capital charge), without having to make unnecessary changes to the financial statements. In addition, we think it will be useful if the FSA continues to emphasise the principles for remuneration it has already set out and takes account of the recommendations in the forthcoming *Walker Review*.

91. An additional matter to consider is that a remuneration system linked to movements in the ECR would see relatively higher executive remuneration during a downturn than would otherwise be the case. Shareholders and regulators may not welcome this and there may be adverse market, media and political reactions. If, as a consequence, it were to be prevented, say by regulatory restrictions on the uses of reversals of ECR, it would seem to undermine the whole purpose of the ECR with regard to reducing pro-cycliality. If the actual intent is to create additional capital in the system that is only available to cover losses, then this could more effectively be addressed through adequately disclosed capital requirements, without impacting financial reporting.

**Directors Duties**

92. If the FSA pursues this proposal, we believe any final recommendations in this area should make it clear that any counter-cyclical measures that directors will be required to take in relation to the management of the affairs of a bank (whether reflected in the accounts or not) are not intended to interpret or set a precedent as to the time horizon for the long term under *s172(1)(a) of the Companies Act 2006* either for the generality of companies or for banks or as to

banking business. The counter-cyclical measures are devised for a purpose different from that of duties to shareholders. The need for them arises from the special role of banks as takers of deposits from the public and as providers of liquidity to the entire economy.

***Q13: Do you agree that serious consideration needs to be given to establishing some form of global supervisory architecture for international audit firms?***

93. We are very concious of the increasing internationalisation of audit firms and support the development of international, multi-disciplinary structures in a direction which promotes greater consistency of quality across borders. We also recognise that the development of international structures of professional services firms has an important regulatory dimension. Regulations can, where there is appropriate pooling of regulatory approaches and coordination between regulators, support the drive for consistency of quality. Equally, where regulations are fragmented,overlapping and even conflicting across jurisdictions, they can significantly hinder progress in the direction of quality and, more broadly, cross-border activities. In our view, at the present time, the regulatory context is characterised by an excessively fragmented, jurisdiction-specific approach with only modest pooling of regulatory initiatives. There is a great deal of useful work which could be done to improve the operation of the existing supervisory architecture.

94. With particular reference to the European context, our view is that the operation of trans-national organisations and practices within the profession is currently hindered, by the divergence in regulations which apply to audit and professional services firms across European jurisdictions. On issues as diverse as registration; ownership; independence; advertising and the provision of services, a raft of different rules apply which vary by jurisdiction. This diversity, and the impact on the profession's trans-national structures to respond to market demands, are explored in detail in the Fédération des Experts Comptables Européens (FEE) report 'Trans-national organisations and practices within the accountancy profession'. For a further discussion of these issues around control structures and the relationship to broader considerations concerning choice in the audit sphere, we would direct you to our recent *ICAEW Rep 37/09, Control Structures in Audit Firms and their Consequences on the Audit Marke'*. We would also draw attention to concerns, which the ICAEW has expressed on other occasions, regarding implementation of the network definition, the importance of which has also been recognised by the European Parliament in calling on the European Commission to undertake a comprehensive review. Furthermore, the ICAEW is also concerned about different rules covering transfer of audit working papers.

95. Many of the issues referred to in the paragraph above are relevant not only in the European Union context but at a broader international level. We believe that in many cases, greater coordination or pooling of regulatory approaches, both within the EU and more broadly, could address many variations and duplication of rules which do not serve the public interest and pose challenges for regulators when seeking to enhance cooperation. We recognise that it is not practicable, or desirable, to expect full harmonisation of rules, given national legal contexts and cultures differ. However, we would advocate greater pooling of regulatory approaches to remove, where possible, differences which do not serve, or actually undermine the public interest, and to help achieve mutual undertanding and reliance between regulators. In this area, ensuring effective and appropriate implementation of the EU Statutory Audit Directive, presents a

valuable opportunity at both the European and global levels. We believe that this approach will prove more effective than seeking to establish a new global supervisory architecture.

96. Box 5.3 of the DP refers to a regime which would consider the ability of firms to meet financial claims. We are uncertain as to exactly what role is envisaged here for a global regulator or of the reasoning behind it. We would note that the situation regarding liability for statutory audits and the availability of insurance differs, and in some cases markedly so, across EU jurisdictions and indeed across the world. This subject is now better understood at European and international level given recent high-level debates. An important contribution in enhancing understanding has been provided through the study undertaken for the European Commission by London Economics[1] which has demonstrated the imbalance between liability exposure and resources within the audit firms and that there is no insurance commercially available for a significant part of the overall audit market. The European Commission's Recommendation on Auditor Liability of June 2008 underlines the importance attached to achieving effective reform in this area, which is required both within EU jurisdictions and more broadly.

97. We think that global supervision would be unworkable in practice, for the reasons identified in the DP. However, as we have explained above, more use could be made of existing tools and relationships. We agree that a strengthening over time of the International Forum of Independent Audit Regulators would be a useful step forward

## Non Audit Services

98. The DP states that '*there is no regulation of non-audit services. Yet the major accountancy firms derive substantial income from non-audit services, such as tax advice, and the provision of such services may pose financial and reputational threats to firms'* (Box 5.3). This statement is open to a number of interpretations. One interpretation is that a failure in the provision of non-audit services could cause a major firm to cease to exist. Another interpretation is that such firms derive such substantial income from non-audit services to audit clients that the integrity of their audit is compromised. We would like to offer comments on both of these themes.

99. We recognise that regulators have a valid interest in the governance of multi-disciplinary audit, accountancy and advisory firms, not least as they may need to develop their own position on work performed by these firms for regulated clients. The ICAEW is engaged on an important project concerning the governance of multi-disciplinary audit, accountancy and advisory firms which, will consider the governance of the provision of non-audit services. At the request of the FRC, we established an independent Audit Firm Governance (AFG) Working Group to develop a code of governance for firms that audit public interest entities. In their October 2008 evidence gathering consultation paper, the AFG Working Group asked for input to a number of issues including: who are the stakeholders of firms; risk management; international structures of the firms; governance structures and independent non-executives; monitoring and reporting. It is believed that a second consultation paper, including a draft code, will be issued by the AFG Working Group in the summer. The draft code

1 Study on the Economic Impact of Auditors' Liability Regimes – Final report to EC-DG Internal Market and Services London Economics (September 2006).

is designed to give comfort to stakeholders about how the non-audit parts of the business are run.

100. Furthermore, it is important to avoid any potential misinterpretations in referring to the fact that many of the non-audit services are not regulated. It is, of course, the case that the provision of many ‘non-audit services’ is not restricted to holders of particular qualifications or licenses in the UK, and indeed in many other EU jurisdictions. However, in the cases where there is, at the national level overall, a free-market situation of ‘non-regulation’, professional bodies often impose additional restraints when providing these services. Audit firms regulated by the ICAEW, for example, are subject to supervision under our Practice Assurance scheme, which covers all professional services not supervised by another regulator, such as the FRC or FSA. Furthermore, within accountancy and audit firms, there are guidelines and procedures governing the provision of these services. In the UK, the FSA itself regulates financial services firms.

**Non-audit services to clients**

101. Returning to the second interpretation of the statement in the DP, concerning auditor independence and objectivity, we would like to offer a number of comments in this regard, addressing the type of restrictions on non-audit services to audit clients and highlighting a specific disclosure problem in this area.

102. In this section, we set out the UK requirements before taking an international perspective. First, auditors in the UK and Republic of Ireland must follow the Auditing Practices Board (APB’s) Ethical Standards (ES), which require auditors to conduct themselves with integrity and to be objective and independent. The APB’s *Ethical Standard 5 Non-audit services Provided to Audit Clients (Revised)* imposes specific restrictions on non-audit services. Auditors are expected to identify and evaluate threats to integrity, objectivity and independence and if significant, implement safeguards to eliminate the threat before undertaking the proposed engagement to provide advisory or consulting services. The Standard also contains extensive restrictions in relation to the provision of non-audit services. The Ethical Standards were developed following full due process, and have been kept up to date by way of a revision process. We continue to be happy to cooperate with the APB in any review of the ethical rules and in particular the adoption in the UK of the IFAC ethical code. In summary, there is regulation of non-audit services to audit clients in the UK.

103. On the subject of the provision of non-audit services to audit clients, we would add that there are disclosure requirements which require an analysis in the annual financial statements of audit and non audit services. In addition, the Combined Code and the FRC's *Smith Guidance for Audit Committees* expects detailed consideration of the company's policy on commissioning non audit services. The result of this and of the shareholders voting at Annual General Meetings on the audit appointment has meant that since 2002 there has been an ongoing and considerable reduction in the level of non audit services provided by auditors of listed companies. Early results indicate that a significant proportion of non-audit services are audit related. The ICAEW Financial Services Faculty is currently undertaking research into the level of non-audit fees in regulated financial services firms.

104. The effect of these changes is that in the UK the system of transparency, governance and shareholder empowerment removes the need for arbitrary restrictions. We note that the reports of the Treasury Select Committee and of the House of Lords Economic Affairs Committee did not find that auditors had failed in their duties or failed to act objectively. Similarly no link was established between non audit services and the financial crisis. Indeed an eminent academic told the Treasury Select Committee that the issue of non audit services is a red herring. Given that the *Turner Review* did not identify the audit as a problem area that needed addressing, we do not feel it is an area for the FSA to work on. There is a need to avoid an unwarranted regulatory over-reaction which would be a source of much red tape for business and of increased cost when the real issue is the need to improve the overall economy.

105. Taking an international perspective, auditors adhere to the independence requirements of Section 290 of the International Federation of Accountants' (IFAC) Code of Ethics. This also has extensive restrictions on the provision of non-audit services to audit clients. IFAC's Consultative Advisory Group includes IOSCO as a member, and input relevant to banks will have been received in the development of the Code. At the ICAEW we are supportive of proposals to harmonise the ethical standards used for audit in the UK with those developed by IFAC for assurance work. However, we do not advocate harmonisation at any price: international standards need to be workable as well as acceptable in qualitative terms. While there are differences in some independence requirements between the APB Ethical Standards and the IFAC Code of Ethics, the IFAC's Code of Ethics has been adopted by the majority of the accounting profession round the world. International harmonisation of the independence requirements relating to audit engagements is likely to lead to reduced business costs, for both audit firms and corporates and may encourage smaller network audit firms to participate in international audits. Harmonisation in this area may also contribute to and more confidence globally. In particular, the International Standards on Auditing and the Revised IFAC Code of Ethics are key building blocks for a more global approach for the larger audit firms to operate which could not be achieved by the continuation of different ethical standards in each country. It would assist overseas investors and the referral of audit work between countries, reducing the level of red tape for audit firms and their clients, which currently have to cope with different ethical rules in different countries. We anticipate this would have a similar positive effect on confidence in audited financial statement as the adoption of international standards on auditing. The APB has recently adopted clarified ISAs but we would welcome a public debate on the route map that the UK should take to adopt the Code of Ethics which will be issued with upgraded content and drafting conventions shortly.

106. Whilst the Treasury Committee's recent report has brought to the fore concerns about independence, we would argue that attention should be focussed on objectivity and competence as well as independence. In our view, objectivity, being a state of mind, is more important but also more difficult to police and evade than is compliance with rules on independence. The principal advantage of a focus on objectivity rather than independence is that it casts the burden of proof on to the firm when judgement is impaired and is thus the better measure, which is what the ethical guides provide for. It then up to regulators to police properly, and in the UK the Financial Reporting Council's inspection regime performs this role. We note that the Treasury Committee has suggested the FRC review the issue of independence. We will respond to the FRC should

they undertake work in this area, and will set out our views in more detail at that point.

**Disclosures on non-audit services**

107. We think the Companies Act disclosures may give rise to a misperception that auditors are performing work which conflicts with their role where it is in fact consistent with their duties and does not give rise to a conflict of interest. Current disclosure requirements for auditors' remuneration are highly prescriptive and cannot be grasped intuitively. We have developed *Technical Release* 06/06 *Revised Disclosure of Auditor Remuneration* to assist those responsible for making the disclosures. As this guidance explains, the category 'Other services' includes work which is most efficiently performed by the company's auditor without causing a conflict of interest - including assurance and attest engagements requiring independence but which do not need to be carried out by law by the appointed auditor. For example, remuneration for the audit of accounts of subsidiaries could be disclosed under 'Other services'. The disclosure requirements may inadvertently obscure what auditors are remunerated for, and contribute to a misperception that auditors are providing an inappropriate level of consultancy services to audit clients. We would welcome an urgent review of the disclosure requirements as we consider they may be giving rise to misperception of work performed by auditors.

***Q14: What macro-prudential policy tools should be considered other than those mentioned in this DP?***

108. Macro-prudential supervision involves three tasks:
- Monitoring. This typically involves the collection of standardised information that can be aggregated across firms. This information may not be that which is the most relevant for the micro-prudential task of regulating that firm, and may involve duplication and/or additional cost.
- Analysis of this information.
- Action on the basis of that analysis, which is above and beyond that implied by micro-prudential needs as traditionally defined.

109. It is easier to justify the costs of monitoring, and the action that results, if it can be shown to be in the best interests of the firm itself in the long-term. This can be done either directly (eg if the FSA takes the view that every firm needs to hold capital against losses inherent but not yet incurred in its portfolio) or indirectly (all firms lose out if financial markets cease to work, even if the initial problem is not at 'your' firm).

110. Most of the tools considered in this paper fall into the first category, and relate to the firm itself (counter-cyclical capital, leverage ratio, core funding ratio). But linkages between firms matter too. Although it has large exposure rules, the FSA has otherwise tended to shy away from action in this area (eg banning ratings-linked collateral triggers), although operating directly on such linkages may reduce the risk of a problem at one firm spreading to others.

111. We are sceptical as to whether some of the suggestions made in the past (eg monitoring 'crowded trades') would operate effectively in practice – such information is costly to collect and is rapidly out-of-date. But analysing how the linkages between firms might operate under stress might generate some insights on alternative macro-prudential tools.

***Q15: What are your views on the effectiveness of a core-funding ratio as a measure to constrain excessive asset growth?***

112. We have real issues with the idea that this concept should be adopted across the board. It would bite most on classic investment banks without retail funding – and we do not believe that this is appropriate, nor that such firms should be encouraged to switch to the retail funding market. We agree with those who say that the risks in a network such as the financial system are greater if all the players become more homogenous. There are also risks to consumers if wholesale banks feel the need to bid aggressively for retail deposits.

113. That said, using liquidity tools to constrain retail firms that wish to grow rapidly seems to us sensible, if it is applied proportionately (and not to penalise eg new entrants). This though might most easily be done via the new approach to liquidity policy, rather than through a core funding ratio.

***Q16: What types of institutions should be exempt from such a core funding ratio? How would any exemptions limit the effectiveness of the measure?***

114. We have reservations about the usefulness of this concept – see previous answer.

115. In applying such a policy, careful thought needs to be given to the position of UK branches of overseas of overseas firms. We doubt whether they should be included within the regime, not least given the FSA's nervousness about encouraging such firms to attract a large retail deposit book in the UK. For similar reasons we also believe that investment banks, and other institutions that are not commercial banks, should be exempt from any such regime.

***Q17: To what extent would market discipline and the convergence of supervisory practices be improved by the disclosure of information relating to Pillar 2 assessment? What information would be most useful?***

116. As set out in the answer to *question 12* above, the disclosure of entity-specific capital requirements under Pillar II would inform users about the risk assessment of the regulator. Either the capital requirements themselves or some insight into the judgements made by the regulators in setting the requirements could serve to encourage the convergence of supervisory practices and may have some benefit in terms of market discipline. In our view, it would be misleading to impose a disclosure requirement about an ECR without also disclosing any other restrictions imposed by regulators which could impact distributions and which will also have significant value for investors. However, the reasons why there is no disclosure of information relating to the Pillar 2 assessment may still be valid so the FSA will need to weigh up the pros and cons of improving disclosure in this area and discuss this in detail with the banks.

**Scope of regulation**

***Q18: Are there other considerations that are relevant to the assessment of the issues and risks posed by the boundary question?***

117. In general terms, we believe that the DP provides a useful summary and assessment of the issues and risks.

***Q19: Is the escalating response set out here the right way to deal with the threats to financial stability and consumer protection posed by unregulated financial activities and institutions? Or should the FSA, along with other regulators, develop an alternative approach?***

118. In general terms, we support the approach outlined in the escalating response as set out in the DP. At times of crisis, market imperfections tend to be exaggerated and a reflective, measured and balanced long-term approach is therefore required. The approach as described in the DP should be capable of managing the risks posed by unregulated financial activities and institutions.

119. As regards protecting the long-term interests of retail consumers, the ICAEW believes that these are best served by market driven solutions. When more stable market conditions have been restored, and subject to the protection of retail consumers through Treating Customers Fairly (TCF) and the implementation of the Retail Distribution Review (RDR), the market remains the most effective mechanism for delivering best choice at the most competitive price.

120. The needs of retail consumers are disparate. The regulation of retail financial services should therefore remain focused on the delivery of suitable advice within a framework of comprehensible disclosure, where the risks associated with any particular product and course of action are fully understood by all parties. The effective implementation of existing regulatory requirements, which already includes the requirement to assess the suitability and affordability of regulated products and associated risks, should have addressed any potential problems in the residential mortgage market. We do not believe that a switch in emphasis toward the regulation of products would be in the best long-term interests of consumers.

121. In circumstances where the unregulated activities of financial institutions pose a threat to retail consumers and financial stability, review of the regulatory boundaries needs to be undertaken. In the context of the escalating response as referred to in the DP, the ICAEW therefore believes that consideration should be given to extending regulation to the secondary consumer credit markets, such as the way second mortgages and unsecured loans are sold.

***Q20: What are the implications of subjecting parent holding companies for financial services groups to direct powers to comply with the requirements of the prudential framework?***

122. The paper is not clear as to what future problems such wide ranging regulatory powers would be trying to prevent. It is also not clear that the issues of jurisdiction and extraterritoriality have been given sufficient thought. Is it appropriate for the FSA to capture, for example all the activities of General Electric in supervising GE Capital? Would the FSA have sufficient resources and expertise to review such information?

123. An approach that the FSA could take would be vigilance coupled with macro-prudential supervision and regular review of the scope of supervision to ensure its completeness and adequacy for purpose. In some situations, eg where the board of the bank and the holding company are the same and the FSA has full visibility over the risks being taken in the group, then the application of full prudential supervision of the group seems unnecessary. In other situations, the FSA could make use of the FSA's existing principles to ensure that the senior

management of firms, including non-executive directors, are expected to be aware of the full set of risks to which the group is exposed and how they are managed, and to report to the FSA issues which the regulator would reasonably expect to be made aware.

**Systemically important firms**

***Q21: Are there other issues which regulators should take into account when assessing their response to the evidence from the current crisis that some financial institutions have been deemed too big to fail fully? If so, what are they?***

124. We believe that the issue of higher capital requirements for higher impact firms is of key importance, not least as it has been raised recently by Lord Turner in his New York speech. It would require international agreement in order to work effectively.

***Q22: What are your views on the balance between varying the intensity of supervision according to the impact and risk that an individual firm poses, and having policy frameworks and approaches that differentiate across-the-board according to a firm's systemic significance?***

125. With the possible exception of capital requirements, we believe that it would be simplest to vary the intensity of supervision firm-by-firm, and not set a framework where an attempt was made to hard-code adjustments to each policy according to systemic issues.

**Groups and intra-group exposures**

***Q23: Are there other aspects of group structures that the FSA should be taking into account?***

126. The analysis in *DP09/02* and the *Turner Review* itself is comprehensive, and we welcome the emphasis for supervisors on gaining a proper understanding of how groups operate within their matrix management structure. It is critical for supervisors of business whose parents or Head Offices are overseas to understand not only the regional governance structure in place, but also the importance attached to regional governance at Head Office and by the group board. The same of course should apply to groups whose headquarters are within the United Kingdom.

127. As regards branches of overseas banks operating in the United Kingdom, it is particularly important for supervisors to understand fully the relationships between such branches and their Head Offices and indeed other branches, and to take the necessary steps to protect retail depositors in the United Kingdom. We are however concerned that the UK may move in directions that jeopardise the attractiveness of the UK as a financial centre by moving ahead of other EEA member states in terms of requirements for subsidiarisation, capital and liquidity. It is important to distinguish the natural consumer protection concern in relation to branches of banks that are actively gathering retail deposits from the wider financial stability issues in relation more particularly to wholesale financial services operations which should more properly be addressed at a global or at least regional level.

128. We consider that supervisors should focus not only on SPEs, SIVs, and conduits established by the regulated entity, but also its significant equity investments in other financial institutions, even if below 50%, to understand the way in which the group manages the risks and commitments involved.

129. The accounting standards in relation to consolidation of subsidiaries and other entities are not designed to reflect prudential risks in all respects: prudential regulators have the ability to determine separately which vehicles should be consolidated for prudential reporting purposes, and should use that power.

***Q24: Is the increased focus on group structures and intra-group relationships and increased supervisory cooperation the right way to deal with the threats to financial stability and consumer protection posed by large, international group structures? In what circumstances would a greater focus on individual legal entities be warranted?***

130. We welcome the proposed increased focus on group structures, intra-group relationships and increased supervisory cooperation as well as legal entities. This will enable supervisors and senior management alike to focus on common risk indicators. However, in an insolvency it remains the case that administrators or liquidators have to focus on each legal entity separately, so supervisors must continue to satisfy themselves that legal entity issues have been adequately addressed, including both liquidity and capital, through intra-group arrangements. This should be achieved by proper monitoring of regulatory returns for individual legal entities by supervisory teams, but if exception reports indicate unexpected changes within particular legal entities, supervisors will need to react swiftly to ensure that regional or group management is properly aware of what has caused the changes and is taking action.

**Responding to events – international architecture**

***Q25: How can the international architecture be arranged to provide the most effective early warning of threats to financial stability and challenge to national authorities and in an apolitical way?***

131. Since the *Turner Review* and *DP09/02* were issued the G20 has of course agreed on an increased role for the Financial Stability Forum, renamed the Financial Stability Board (FSB), which we welcome. We consider that there is a danger in seeking a profusion of international bodies to provide both macro-prudential supervision and oversight of national micro-prudential bodies, which could dilute the impact of each. We consider that the FSA should give its full support to the increased role for the FSB, working together with the new authorities at Lamfalussy Level 3 which were proposed by the De Larosière report and now endorsed by the European Commission. The wider remit of the FSB as opposed to a purely European body is an important consideration here. The Bank of England, with the increased Financial Stability and macro-prudential role now proposed, also has an important role to play and it is important that it and the FSA work closely together to ensure the United Kingdom contributes effectively to international decision-making.

132. It is important that organisations such as the Committee of European Banking Supervisors (CEBS) and the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) apply a consistent approach to capital treatment in respect of common issues. For example, recent proposals

by CEIOPS to consider pension obligations on an economic basis rather than IFRS (accounting) basis for Solvency II purposes, contrasts with Basel II requirements for banks. However, the substance of such obligations are no different whether they reside within a bank or an insurer.

***Q26: Is this the most effective way of organising colleges on the one hand and crisis management groups on the other?***

133. We welcome FSA's proposals in respect of supervisory colleges and crisis management groups. It is very important that FSA does not over-commit its scarce highly talented resource for representing the UK on such bodies, while bearing in mind that both colleges and crisis management groups will only work if the right people are on them.

***Q27: Do these options represent the right approach to the problems posed by EEA branching?***

134. We welcome the clear and careful articulation of the problems presented by passporting and branching in Lord Turner's review and *DP09/02*. As we noted in our response to Q23, however, we are concerned that this analysis may lead the FSA to move in directions that jeopardise the attraction of London and indeed the United Kingdom generally as a financial centre by moving ahead of its European partners in terms of requirements for subsidiarisation, capital and liquidity. It is important to distinguish the natural consumer protection concern in relation to branches of banks that are actively gathering retail deposits from the wider financial stability issues in relation more particularly to wholesale financial services operations which should more properly be addressed at a global or at least regional level.

135. The options proposed by the FSA in *paragraph 9.16* represent a good analysis of the choices available, but it is important to complement option 'a' with the peer reviews envisaged at the FSB global level. Within option 'b' we consider that host supervisors should have the right to restrict retail deposit taking as opposed to other activities in the circumstances described within that sub-paragraph.

***Q28: Are the functions of rule-making capability and supervisory oversight the right ones to be given to a European institution that has the characteristics described here?***

136. As we have indicated in our response to *question 25*, we consider that the need for the establishment of the body envisaged in *paragraph 9.24 in DP09/2*, which would not be without controversy within the European Economic Area (EEA), could to a considerable extent be obviated by the increased role of the FSB now agreed at the G20 level, complemented by the new authorities proposed by de Larosière. We do not see how the proposals in *paragraph 9.24* overcome the desire for independence in such respects by territories for whom rescuing a bank is a considerable fiscal burden, and for whom the regulation of banks and protection of depositors has now become a highly politicised issue. Given therefore the resistance that the increased powers that FSA proposes for a European oversight body would be likely to incur, we consider it would be more pragmatic to devote FSA and Bank of England resources to making the new de Larosière authorities really effective and cooperating fully to increase the impact of the FSB. It is also important to remember the importance for effective supervision of close linkages between line supervisors and policy

teams, which might be put in jeopardy if policymaking takes place exclusively at a regional or global level. We believe that is essential that national regulators should have policy team(s) close to the line supervisors to interact with the regional or global body.

137. It is also very important that the international organisations have sufficient highly-skilled staff and appropriate financial resources to be effective.

**Market issues**

***Q29: Does the DP highlight the correct issues concerning the role of CRAs and the use of their ratings?***

138. We have no comments with respect to this question.

***Q30: Are the approaches outlined to address these issues appropriate and proportionate?***

139. We have no comments with respect to this question.

***Q31: What options should a review of the use of structured finance ratings in the regulatory framework consider?***

140. We have no comments with respect to this question.

***Q32: Is this the most appropriate framework for post-trade transparency or are there other aspects we should be considering?***

141. We have no comments with respect to this question.

***Q33: Are there other measures which the FSA should be considering or promoting in international fora?***

142. We have no comments with respect to this question.

***Q34: What other considerations should the FSA take into account with respect to OTC derivatives infrastructure?***

143. A key factor in assessing Over The Counter (OTC) derivatives infrastructure, which has often been overlooked, is that its mark-to-market valuation is calibrated on trader quotes for new deals for benchmark maturities. The secondary market extracts a higher bid-offer premium, typically ranging from 3% to 10% and more, depending on the complexity of the OTC derivative and the remaining maturity, that is not accrued in the hedging costs. The added transactional spread also does not factor in the specific counter-party credit and any changes since the inception of the deal. We suggest multi-period hedging risk matrix be incorporated within the re-valuation infrastructure for OTC derivatives in an otherwise heavily proprietary modelling dependent process. This will also improve transparency, especially to the impaired asset classes including structured credit derivatives.

***Q35: Are any (other) changes to clearing arrangements needed? If so, what should they be?***

144. We have no comments with respect to this question.

***Q36: Are any changes to settlement arrangements needed? If so, what should they be?***

145. We have no comments with respect to this question.

**Implications for other regulated sectors**

***Q37: Which of the issues set out for discussion in this DP are most relevant to other regulated sectors?***

146. It is widely recognised (including by the *Turner review* and DP itself) that many of the issues arising are specific to the banking sector. Accordingly it is important to consider those specific aspects that relate to banks rather than other sectors such as insurance to avoid inadvertent consequences of wider application. There are significant differences between the business models of banks and other financial services providers such as insurance, particularly in relation to funding where insurers are funded by advance premium payments unlike banks, which rely on short-term deposit or short-term credit funding. Insurers are therefore much less susceptible to 'liquidity' issues. When interbank lending seized up and credit activity at banks was severely reduced, most insurance markets continued to operate normally. Insurers have maintained normal relations with their clients, accepting new risks and paying due claims. In this regard the capital adequacy, accounting and liquidity proposals as drafted are specific to the banking sector.

147. Regulation also needs to reflect the specifics of different financial services sectors. We do not necessarily support the concept of a single, integrated EU supervisor for banking, insurance and securities. It is important that the distinct natures and risk profiles of the sectors are recognised. In the current environment where there is a high degree of focus on banking regulation and the regulatory framework faces a period of intense change, there is too great a risk that an integrated EU supervisor would lead to insurers being subject to inappropriate prudential requirements designed to suit a banking model. Whilst we support in principle convergence of global and regional regulatory frameworks in the interests of consistency and standardisation of international supervision, we see supervisory convergence for insurance at an EU level as a realistic medium term goal, and we would like to see practical, evolutionary steps towards it.

148. Whilst we consider most of the issues within the discussion paper are specific to the banking sector we acknowledge that issues in relation to regulatory philosophy including governance and risk management and the approach to groups have wider applicability. We also agree that quality of capital issues are less complex in insurance than banking.

***Q38: Are there any lessons which have been learned in other sectors which could be applied to banking?***

149. Prior to the introduction of IFRS, insurance entities were required to include an equalisation provision in their financial report and accounts. This had similar objectives as the dynamic provisioning (being to smooth through the cycle) now being proposed for the banking sector. Under UK GAAP this statutory requirement was reported as an emphasis of matter within the audit opinion since it did not represent a liability at the balance sheet date. Elimination of equalisation reserves from insurers' accounts with the introduction of IFRS was

seen as a step forward in achieving greater transparency and a more appropriate measurement of the insurance liabilities. Given this background, it would be unfortunate if this was reintroduced as dynamic provisioning, without all of these points having been much more fully addressed. In our view adjustments to set up such reserves should not be incorporated into financial reporting to shareholders.

**Other Comments**

**Supervisory Approach**

150. Communication and coordination between the tri-partite authorities can be improved. The FSA, Bank of England and Treasury each had responsibilities for systemic risk, but there was insufficient clarity in the past over the interaction between their respective responsibilities. As a result, while each of the tri-partite authorities may have issued warnings over various macro-economic risks, none took responsibility for addressing those risks.

151. In any regulatory framework, there will always be tensions over where dividing lines should be set when more than one authority is involved. Clear definitions of the respective responsibilities among the tri-partite authorities are more important than the choice of which organisation takes on which role.

152. The FSA makes the case for maintaining its current structure. This requires it to demonstrate that it will develop the staff capabilities to perform these functions and, more importantly, develop internal processes that ensure the sharing and analysis of information/capital flows/risk concentrations across sectors (eg banks, insurance, asset management, hedge funds etc). The proposals at present are very broad and do not explain how this will be achieved.

153. The DP sets out seven sensible and practical 'central enablers' in Box 11.1. Overall we are supportive of these enablers but have a few concerns in relation to their execution:
    a. Competence: the proposed T&C programme, while admirable in its scope, does not deliver the most important outcome - competence in managing (or understanding the management of) a complex financial services business. While we accept that in practice it will never be possible to have all staff competent in this area, we believe that the lack of first-hand experience in the FSA leads to a significant amount of conflict, misunderstanding and less well informed decision-making. This is particularly relevant in the more intrusive, 'judgements on judgements' era that we are entering. Perhaps more firm secondments (both ways) could improve current weaknesses in this area.
    b. Tenure: for a number of years the FSA has been promising firms that it will ensure the continuity of its staff on their supervision teams, but has had great difficulty in achieving this. Unless it can support this statement with a clear credible plan we wonder whether the FSA will be successful in this area.
    c. Culture: an admirable ambition but in the past there has often appeared to be a palpable fear at the FSA of making any decision at all. This ethos will have increased in the current environment with the potential for every move by the FSA to be reviewed by the Treasury Select Committee for hindsight dissection. Again, unless the FSA establishes and communicates a clear and credible plan to deliver the required cultural

change there will be scepticism over the organisation's ability to deliver on this ambition.

154. In summary we are supportive of the approach set out in Section 11 of DP 09/2, but without greater evidence to support the steps proposed and the execution of this approach, we are sceptical over the FSA's ability to achieve it based on past experience.

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## Appendix – Ideas for enhancing confidence in banking reporting

THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES

10 February 2009

Our ref: ICAEW Rep 60/09

Rt Hon John McFall MP
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Dear John

**IDEAS FOR ENHANCING CONFIDENCE IN BANK REPORTING**

I am writing to follow up on matters raised at the Treasury Committee's panel sessions on 28th January 2009 on the role of auditors of UK banks. The Financial Services Faculty at the Institute of Chartered Accountants in England and Wales (ICAEW) is pleased to submit ideas, set out in the attached note, as to how the role of auditors might be extended to enhance confidence in bank reporting.

The ICAEW Financial Services Faculty was established in 2007 to address, in the public interest, issues and challenges facing the financial services industry. In developing these ideas for the Committee, the Faculty has consulted with practitioners in six audit firms engaged in the audit of banks in the UK: BDO Stoy Hayward, Deloitte, Ernst and Young, Grant Thornton, KPMG and PricewaterhouseCoopers.

We look forward to exploring these ideas further with the tripartite authorities and the representatives of banking industry. In the meantime, if you have any queries please contact me or Iain Coke, Head of the Financial Services Faculty at iain.coke@icaew.com.

Yours sincerely

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THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES

# IDEAS FOR ENHANCING CONFIDENCE IN BANK REPORTING

## Introduction

The Treasury Committee, at its hearing on the role of auditors in the banking crisis on 28 January 2009, invited the major auditing firms to suggest areas where the role of auditors might be strengthened in the audit of banks. The ICAEW Financial Services Faculty is responding to this invitation after consulting with practitioners in the six largest UK auditing firms.

In summing up these sessions, the Chairman, the Rt Hon John McFall MP, said that auditors had done a decent job of fulfilling the duties expected of them in statute but questioned whether that role was appropriate. The relationship between auditors and the Financial Services Authority (FSA) is central to that question. To help the Committee consider these matters, we set out five areas where the role of auditors could be extended:

1. Financial information outside the accounts
2. 'Pillar 3' risk disclosures
3. Regulatory returns to the FSA
4. Control activities chosen by the FSA
5. Bank-specific meetings with the FSA

The aim of these ideas is to contribute to enhanced public confidence in banks by increasing trust in the information that banks report to the public and to the regulator. Currently, auditors focus on banks' financial statements specifically and work in the interests of shareholders. The wider public may not understand that auditors have only limited involvement with other financial information provided by banks.

The audit profession can contribute to greater confidence in banks by providing objective, expert opinions on the information reported by banks, so that those relying on that information can be confident that it has been properly prepared. In assessing each of the suggestions we make for extending the auditor's role, the following would need further consideration:

- the exact nature of work to be performed, how this fits with current professional standards and whether new guidance would need to be developed;
- consulting stakeholders to ensure that any new measures are practical and add value;
- identifying the costs of implementing change, ongoing costs and how they compare to benefits;
- avoiding the creation of expectation gaps which could damage confidence. For example, assurance work does not provide guarantees and it focuses on the quality of the reported information rather than the appropriateness of the underlying reporting requirements; and
- the international context, including maintaining UK competitiveness and drawing on the best of current thinking.

The following paragraphs set out our ideas in more detail.

## 1. Financial information outside the accounts

Some of the financial information reported by banks does not form part of the audited accounts. For example, banks normally provide capital ratios, which are the regulatory measure of the amount of capital they hold, in their annual report. At the moment, auditing standards require that where information is in the annual report but not part of the accounts 'the auditor should read the other information to identify material inconsistencies with the audited financial statements'. Auditors are not, however, required to obtain additional evidence to support the other information. The UK Government has previously taken the view, after extensive consultation, that it is not necessary to extend the audit scope beyond the financial statements. The FSA and Government should consider doing so for banks, at least in relation to financial information such as capital ratios.

## 2. 'Pillar 3' risk disclosures

In 2009, banks will be required to report greater detail of their risk positions under new regulations introduced by Basel II, called 'Pillar 3' disclosures. Basel II includes an option to require Pillar 3 disclosures to be audited. After consultation, the UK government and FSA took the view that it would not take up this option to require an audit of the disclosures. Many banks are likely to make these disclosures in their annual report, but outside the accounts. In this case auditors will only need to read the disclosures for inconsistency with the financial statements as in 1 above. The rules also allow banks to make Pillar 3 disclosures outside the annual report, for example on their web-site, in which case there is no requirement for auditors to check them. The FSA should reconsider the decision not to require an audit of Pillar 3 disclosures in the light of changed circumstances.

## 3. Regulatory returns to the FSA

Banks' regulatory returns to the FSA include a range of financial information, for example on liquidity, large exposures, a bank's balance sheet and capital. At present, these returns are not subject to review by auditors. The present regime for banks arose under the Financial Services and Markets Act 2000 (FSMA). It differs from the insurance sector, where regulatory returns are reported on by auditors. Before the introduction of FSMA, banks' returns were subject to periodic review by auditors. The FSA should consider whether reintroduction of a review of key bank regulatory returns by auditors would be useful.

## 4. Control activities chosen by the FSA

The FSA has powers under section 166 of FSMA to commission reports by auditors on specific issues. These reports are used mainly when a specific problem has been identified and tend to be forensic in nature and relatively expensive. While it is for the FSA to decide what type of information best supports its supervisory approach, more general reports looking at banks' controls used to be commissioned under the previous regime, when section 39 of the old Banking Act applied. The FSA could make greater and more regular use of their existing powers under section 166 to obtain more information about the operation and application of controls or compliance with regulations.

## 5. Bank-specific meetings with the FSA

Bank auditors are required to communicate with the FSA in specific circumstances, including when they suspect management fraud, consider there are going concern issues or for significant rule breaches. Depending on the nature of the concern, some communications will involve banks' management while others will not. Written communications may be followed up by meetings. Outside these prescribed circumstances, the need for additional contact between auditors, management and the FSA is up to the judgement of the supervisor.

The current situation differs from the old regime where there were regular bipartite and tripartite meetings to discuss the financial statements audit and section 39 reports. It is worth looking at whether more regular meetings with auditors would help the FSA gain additional insights into the banks they regulate. The knowledge that such meetings were taking place ought also reassure the public. Indeed, it could even be made a requirement that periodic meetings are held with the auditors for particularly important regulated banks, so that it is not left to the discretion of the supervisory team. In support of this, we note that the FSA is advocating annual bilateral meetings with the auditors of all high impact firms.

ICAEW Financial Services Faculty
10 February 2009