



INSTITUTE
MEMBERS IN
SCOTLAND

11 September 2009

Economy, Energy and Tourism Committee
Room T3.40
Scottish Parliament
Holyrood
Edinburgh
EH99 1SP

bankinginquiry@scottish.parliament.uk

Dear Sir

Submission of written evidence

The way forward for Scotland's banking, building society and financial services sector

The ICAEW Members in Scotland (IMS) group is pleased to respond to the Economy, Energy and Tourism Committee's call for written evidence on the inquiry into the way forward for Scotland's banking, building society and financial services sector.

We hope that these comments help to inform the inquiry. We are happy to provide any further input or to discuss any of the points raised in more detail.

Yours sincerely

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INTRODUCTION

The ICAEW Members in Scotland (IMS) welcomes the opportunity to submit written evidence to the inquiry into the way forward for Scotland's banking, building society and financial services sector.

IMS is the dedicated Scottish branch of the Institute of Chartered Accountants in England & Wales (ICAEW) serving over 1300 members across the private and public sectors in Scotland. IMS represents the views of ICAEW members who work in Scotland for Scottish and international organisations and disseminates information from ICAEW to its members in Scotland.

ICAEW operates under a Royal Charter, working in the public interest. The 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 ICAEW provides leadership and practical support to over 132,000 members in more than 160 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. The ICAEW is a founding member of the Global Accounting Alliance with over 700,000 members worldwide.

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 ICAEW ensures these skills are constantly developed, recognised and valued.

OUR RESPONSE TO SPECIFIC INQUIRY QUESTIONS

1. What is your view on the cause, nature and impact of the recent difficulties in the financial sector in Scotland?

In the ICAEW's submission to the House of Commons Treasury Committee hearing into Accountancy and the Banking Crisis (November 2008), we stated:

"Broadly, our understanding is that the current financial crisis originated in the combination of vast sub-prime lending in the US, falling American property values that grew out of a period of unprecedented availability of cheap credit, and increases in US interest rates. The collapse in confidence was fuelled by doubt about the viability of many financial institutions holding significant assets that depended directly or indirectly on property lending. Other institutions, which have lent to or invested in firms more directly exposed, have in turn faced losses. Contagion spread throughout a globalised financial system, a process significantly exacerbated by the collapse of Lehman Brothers.

"Concerns about the relative strength of the capital base of a number of leading financial institutions led to reductions in the liquidity available to those institutions, which cumulatively resulted in a sharp contraction of funds available to the banking system generally and the ability of banks to provide credit to the 'real economy'. Banks curtailed lending in order to restore capital ratios to prudent levels. As the excessive willingness of lenders to lend was arguably a leading cause of current problems, it is unsurprising that they are now much more cautious, indeed perhaps over-cautious.

"The contraction of credit is currently precipitating a significant decline in economic activity, which reinforces the risks to systemic financial stability."

Whilst the outcome is yet to be shaken out, it appears that the Scottish banks have suffered heavily in a retrenching of operations, leaving significant numbers formerly employed in financial services in Scotland out of work.

Appendix 1 shows the relation between business confidence in the UK (tracked in the ICAEW quarterly Business Confidence Monitor) and key points in the 'credit crunch'.

2. What evidence do you have on the issue of the availability and the cost of credit and what effect have the initiatives undertaken by the banks, government bodies, regulators and others had?

In July 2009 the ICAEW published a report on SME Access to Finance in the UK (www.icaew.com/smefinance). The key findings included:

- SMEs are finding it harder to access finance, with companies in the construction, property and retail sectors worst affected;

- There appear to be inconsistencies between and even within banks in lending practices, although the general trend is for a far more cautious approach to lending;
- Conflicting pressures are affecting demand for credit: difficult trading conditions heighten the need to borrow while many SMEs decide not to approach their banks for credit for fear of rejection or increased bank charges;
- Relationships between SMEs and lenders are becoming strained and damaged;
- Being judged a 'going concern' – which can cause audit issues - is a major worry for SMEs.
- Some SME advisors feel the cost of borrowing is too high, while others feel it is merely now more realistic;
- There appears to be low awareness among SMEs of government-supported 'health checks' and schemes to help access lending. Schemes are thought to be not very accessible and not working together as a whole;
- The majority of respondents expected the supply of credit to increase within the next three to 12 months. None expected it to fall;
- Reducing company taxes and forcing banks to lend to viable SMEs on reasonable terms are the most popular suggestions for ways in which the government can help, followed by a more proportionate approach to small business regulation.

Anecdotal evidence from talking to members in business in many sectors in Scotland has revealed that finance is generally available, albeit at a higher price than previously. One member, running an on-line retail business expressed great frustration that his bank could not differentiate the cash flow needs of his growing business from the travails of a suffering business and he was seeking finance from a non-banking source to fuel his growth.

3. What changes can be expected as part of the ongoing and future restructuring plans in the financial services sector within Scotland?

As mentioned in our response to question 2, above, ICAEW research shows that the supply of credit to SMEs is expected to increase.

However, initial developments are likely to see risk being priced highly and banks' volume of lending unlikely to be at levels seen recently. To sustain business the pricing will need to be absorbed by businesses which have perhaps got used to borrowing being in plentiful supply at low cost. Once the "new" pricing regime is accepted it is likely that the volume will return as business needs finance to carry on trading.

4. How might these changes affect the business and retail banking market in Scotland, access to project finance, a reduction in competition on the 'high street' for lending, the plans for the retention of functions and 'headquartering' etc and what can the public sector in Scotland do to ensure the best possible result for Scotland?

The competition will continue, although the mergers of financial institutions have reduced the number of names on the High Street. The market has been changing as on-line offers have sought to bypass physical presence and face to face transactions.

The public sector can support both options by ensuring premises are available on High Streets for banks and other lending organisations and by ensuring training and the very different accommodation is available for those wishing to establish call centre operations to make Scotland the destination of choice.

The slides in **Appendix 2** show forecasts from the ICAEW's research, comparing the banking finance and insurance sectors with UK averages, showing that turnover, gross profit and sales are expected to bounce back in the next 12 months, although total salaries (including bonuses) and headcounts are still forecast to decrease.

5. What are the current employment levels and skills base in the financial sector in Scotland and how may these change? Additionally, what are the types of jobs that might be expected to be lost as part of any restructuring plans?

Our research (see **Appendix 2**) shows that employment levels are forecast to drop slightly in the next 12 months in the banking, finance and insurance sector.

The financial services sector in Scotland employs people across the full range of skill levels. Having been well established for many years the skill sets have been nurtured and developed as the sector has grown. The skill

levels are likely to remain as the sector will rebuild employment levels and seek to do this where skilled employees reside.

It is for the financial services companies themselves to restructure their businesses, but in the short-term it would be reasonable to assume that jobs would be expected to be lost in 'front office', processing and sales positions, if those functions are most at risk. Likewise as more emphasis is placed on risk functions, financial regulations and compliance, we may see employment growth in those areas.

6. How are employment levels in the financial sector calculated at present, under what definitions and how do these relate to ONS figures? What changes are required to make employment figures more meaningful and comparable with other financial centres?

This is a question better addressed by ONS, however HMRC of necessity has information on employees in Financial Services businesses, whilst that might include job titles, that is not specific enough on role and skill levels utilised.

7. What are your views on the current efforts across the public sector in Scotland to respond to the recent difficulties in the financial sector in Scotland and what, if anything, needs to change in the future as the situation develops?

One issue in particular which the ICAEW has highlighted in the past is the need for cross border engagement over Financial Services regulation:

A commitment to high quality, principles-based regulation will help restore confidence in the financial services industry. The UK has a leadership role to play in supporting transparent and comparable international reporting standards. An incoming administration should also review the reporting structures and information flows regarding systemic risk in the financial system.

- **Commit to evidence-based, well-resourced, globally coordinated and principles-based financial services regulation:** When developed in cooperation and consultation with international regulatory authorities, proportionate and effective UK regulation will help to enhance confidence in financial markets. To tackle the complexity of financial services regulation, UK regulators need staff with the necessary skills and experience. A principles-based approach to regulation, sufficiently flexible to be relevant to a fast-paced business environment and with an emphasis on ethical codes and practices, should be the bedrock of reform.
- **Support transparent and global financial reporting:** Transparent and reliable financial reporting is integral to building market confidence. In a global marketplace financial reporting standards should be set at the global level, through due process and within the appropriate accountability and governance frameworks. However, in times of crisis there can be huge pressures to limit transparent reporting, for fear of the commercial repercussions, and to withdraw from global standards in order to appease certain national industries. These pressures must be resisted at a political level. Where national or international authorities wish to dampen the effects of the business cycle, this should be introduced through regulatory requirements for information or for holding capital – not through adapting the financial statements. Transparent reporting during the 2007/8 financial crisis is recognised to have highlighted problems sooner than would otherwise have been the case and enabled faster economic recovery. Despite the fact that transparency can be commercially and politically sensitive, the UK must continue its commitment to both transparent and global financial reporting and support greater investment choice and comparability across countries, across industry sectors and across companies.
- **Improve awareness of systemic risk issues across the financial services industry:** One of the major causes of the 2007/8 financial crisis was a collective failure to appreciate systemic risk. There now needs to be a collective spirit of partnership to improve awareness of systemic risk, marked by strong channels of communication and transparency of relevant information. The responsibilities for collecting information and reporting on systemic risk need to be clearly assigned in the UK and new tools are needed to manage this risk at global and local levels. As political attention focuses on financial services regulation and corporate governance reform, the spotlight should also fall on the need to:
 - improve the transparency of bank boards' 'risk appetite';
 - increase the clarity about how risk management information flows to bank boards;
 - work to improve the systems of cross-border regulatory cooperation, highlighting practical cross-border difficulties posed by legal and other constraints;

- promote better dialogue on systemic risk, including regulatory authorities providing periodic risk outlook briefings for relevant non-executive directors and strengthening the relationship between regulators and bank auditors.

8. Has Scotland's reputation as a global financial services centre been detrimentally affected by the global crisis and has this been to any greater extent than the problems felt in other financial centres?

The Scottish banks by retaining "Scotland" so clearly in their title have resulted in brand damage to the nation, even although any fault may be elsewhere. However as the situation has evolved that damage has faded and the problem is seen as a global financial crisis.

9. How should Scotland differentiate itself and promote itself as a financial services centre in the future and what steps are being taken by our competitors in this respect?

Scotland needs to reaffirm its place as a centre of prudent business decisions, where careful planning and sustainable approaches are paramount.

Moving forward, the Scottish financial services sector will have to ensure it has the skill pool and depth of skills available to restore confidence in its abilities.

10. How can we ensure that the Scottish financial sector continues to retain a global perspective and does not retreat into a purely localised lending regime?

The businesses operating in the Financial Services sector remaining in Scotland still include international players. These businesses will overcome the fall-out from the current situation and continue to make their mark globally. The test will be to marry prudence with the bigger markets. Business is displaying an understanding that this philosophy is not "old-fashioned" but rather has a leading place in financing the businesses of tomorrow.

As stated in question 9 above, moving forward, the Scottish financial services sector will have to ensure it has the skill pool and depth of skills available to restore confidence in its abilities.

Also see our comments about cross-border engagement over Financial Services regulation, under question 7 above.

11. Why are "new" banks choosing to establish themselves in Scotland, what is it that is particularly attractive and how can we build on this and attract additional investment into Scotland?

The attraction to new banks is the availability of experienced work force and the heritage of the financial services sector in Scotland. It may be that they too recognise a need to return to former values for a sustainable financial market in the future.

In view of this attraction it is crucial to promote the skills of the financial services workforce in Scotland and to continue to invest in the retention and development of these skills within the workforce.

Resources:

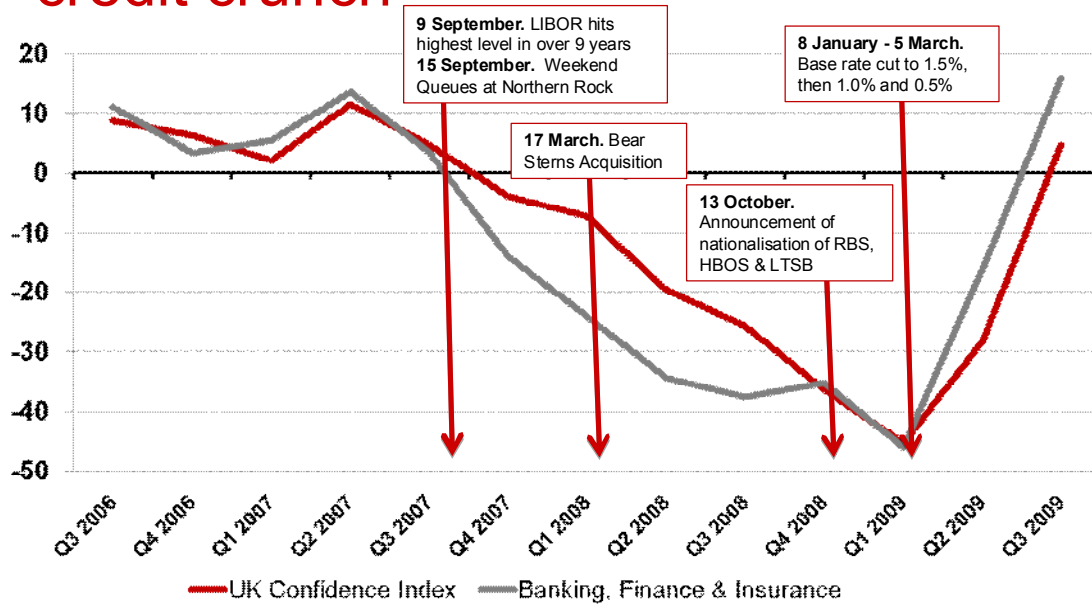
www.icaew.com/index.cfm/route/152605/icaew_ga/en/Technical_and_Business_Topics/Thought_leadership/Inspiring_confidence_in_financial_services/Inspiring_Confidence_in_Financial_Services

www.icaew.com/index.cfm/route/167437/icaew_ga/Members/Member_initiatives/Business_confidence_monitor/Q3_2009_Scotland/pdf

www.icaew.com/sme/finance

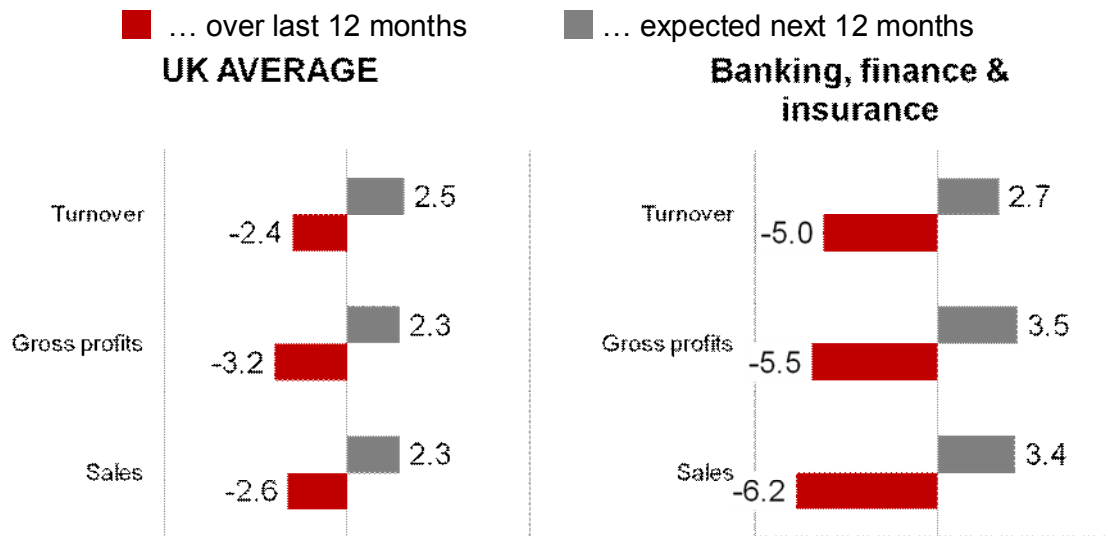
www.icaew.com/g20

Trend in BCM Confidence Index during 'credit crunch'



Q. Overall, how would you describe your confidence in the economic prospects facing your organisation over the next 12 months, compared to the previous 12 months?

Average % change Q3 2009

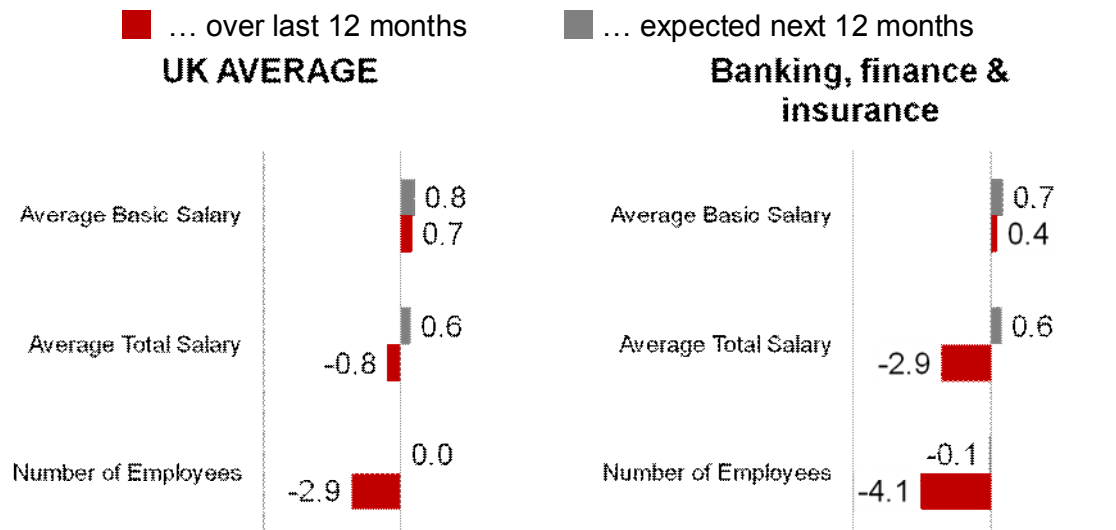


Q. Thinking about the last 12 months, how have each of the following changed for your organisation?
 Q. Thinking about the coming 12 months, what will be the probable change for your organisation for each of

Base: UK - 1000, Banking Finance & Insurance - 105

ICAEW

Average % change Q3 2009



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ICAEW

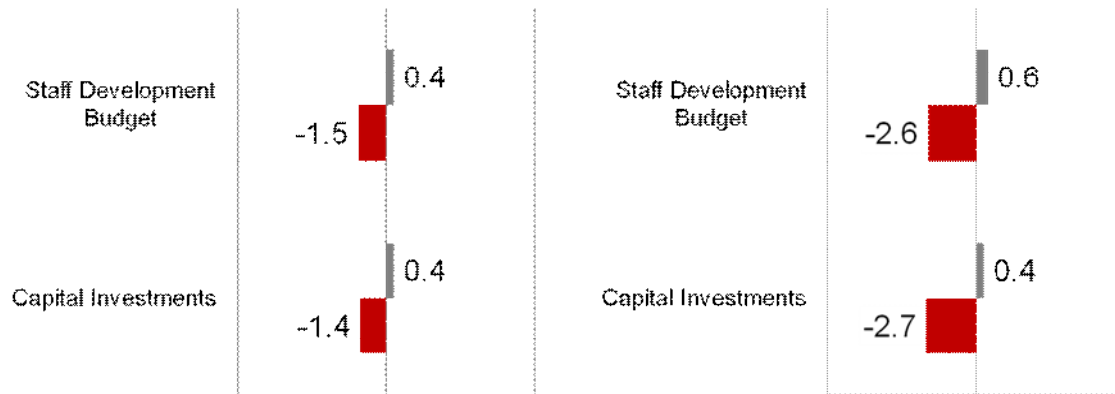
Average % change Q3 2009

■ ... over last 12 months

■ ... expected next 12 months

UK AVERAGE

Banking, finance & insurance



Q. Thinking about the last 12 months, how have each of the following changed for your organisation?

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