



House of Commons  
Treasury Committee

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# Banking Crisis

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## Written Evidence – Part 1

*This is a volume of submissions, relevant to the inquiry Banking Crisis, which have not yet been approved for publication in final form. Any public use of, or reference to, the contents should make clear that it is not yet an approved final record of the written evidence received by the Committee.*

*Only those submissions written specifically for the Committee have been included.*

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**Memorandum from CIPD**

## **CIPD overview**

1. The CIPD's primary purpose is to improve the standard of people management and development across the economy and help our individual members do a better job for themselves and their organisations.
2. As the UK's leading professional body for those involved in the management and development of people, we are ideally placed to contribute to the development of public policy across the spectrum of workplace and employment issues.
3. We are able to draw on the experience and knowledge of our 133,000 members and our wide range of research to provide a pragmatic stance on public policy that is based on solid evidence and the real world.
4. Our membership base is wide, with 59 per cent of our members working in private sector services and manufacturing, 34 per cent working in the public sector and 7 per cent in the not-for-profit sector. In addition 82 per cent of the FTSE 100 companies have CIPD members at director level.

## **Background to the FSA review**

In the UK, the media and politicians have raised concerns that inappropriate remuneration schemes in the City may, in some way, have contributed to the current financial difficulties. These concerns have also been raised internationally, through reports from the Institute of International Finance and the CRMPG. As a consequence, the FSA is now examining remuneration policies across the banking sector as a whole. Given the implications of this review for the wider financially regulated sector and, potentially, for other areas of the economy it is seen as important that the CIPD has a view on the FSA's review.

This paper has been put together following a meeting of the CIPD Vice President's senior reward panel held 3 November 2008.

## **Is remuneration the problem?**

While recognising the scope of the FSA's letter and the legitimate need to explore this aspect of the banking crisis, members of the panel were concerned that the focus of the FSA's letter is solely on remuneration design (levels and structures) looking at the weak points in reward and how they can be strengthened. It does not acknowledge the associated contextual issues which frame any remuneration system such as employee engagement, the culture of performance and hiring practice.

In this paper we examine the FSA's review in more detail, but focus initially on these 'contextual' issues:

Given the tight labour market in investment banking at the time we witnessed:

- high recruitment, training and development costs
- confusion over whether annual incentive deferrals were primarily a retention or a performance tool

- annual incentives deferrals being bought out when people left organisation and so lessening their performance role
- the role of the HR/reward professionals being minimised in terms of assessment of reward design standards with a heavy emphasis on maintaining 'market rates' on salary and bonuses, rather than operating a strong link to performance
- a focus on short-term measurable profit/revenue, with less emphasis on management and reward of rounded performance (including administrative and risk compliance)
- despite the City regarding talent management as being crucial to success, a number of best practices were not universally followed in relation to recruitment, performance management and work force planning.
- a failure, at all levels, to appreciate and manage risk of new products, particularly in the originate to distribute model
- a perception of first mover disadvantage in applying closer controls on aspects of good HR practice and reward

## **The FSA review**

### **1. Remuneration levels**

The FSA does not intend to investigate this area, which would be fraught. It believes that levels are a matter for the board within the context of prudent management of returns to employees and returns to other stakeholders, taking into account performance and risk. The CIPD agrees with this view. The CIPD recognises that the focus of concern at this time should be what the individual is incentivised to do to receive the payment and the management and governance of the process.

### **2. Remuneration structures**

The FSA wants to ensure that firms follow remuneration policies that are aligned with sound risk management systems and controls. However, we believe that is something that goes beyond just incentive design. What is needed is for these organisations to build their reward and people management capabilities.

The CIPD broadly supports many of the FSA's criteria for good remuneration policies and welcomes the approach which avoids detailed guidelines that could be counter-productive in individual instances over diverse business situations.

For example, it is one thing to call for reward to be linked to performance, it is another thing to be able to define, measure, manage, appraise and ascribe it. Unfortunately, there is no one solution and employers have to work out what is best for them within the appropriate regulatory framework

In CIPD's experience, for incentives to work, they should not exist as isolation but as part of a wider, integrated reward and people management approach to meet the needs of the business. That to be effective incentive schemes need to have:

- appropriate and measureable performance targets
- effective communications
- management of all key elements of individual performance

- responsible management
- operate in an environment where scheme participants know what values, performances, skills and behaviours that will be rewarded and recognised.

## **Governance**

It is clear that the remuneration practices which may have contributed to the present crisis operated in an environment where aspects of risk were not systematically understood and managed. This applied right the way from the Boards of banks to regulators, rating agencies and the employees themselves. Given this context, even the best practices of remuneration governance were unlikely to have fully avoided short term potential overpayment for the performance achieved

The CIPD believes that Remuneration Committees of Boards, accompanied by greater transparency and the advisory vote on executive remuneration policy at AGM's has improved governance of remuneration for executive directors. This requires Non Executive Directors sitting on the Remuneration Committee to bring their understanding of the business strategy, risk and operational plans to the design of executive reward within the context of best practice in reward design and people management. Whether it is appropriate or feasible for the Remuneration Committee to have detailed involvement in reward, including incentives, at lower organisation levels is open to doubt given the role of non executives in the UK corporate governance model. However it is clear that there needs to be sound design and management of incentives at lower level, involving individuals are qualified and experienced in reward management, accountable for business performance and not themselves beneficiaries of the arrangements.

The CIPD suggests that the board as a whole needs to regularly review its people management practices to ensure that they encourage the behaviours, attitudes, skills and performances that support the long-term interests of the organisation and the shareholders.

## **Summary**

### **The CIPD believes that:**

- there is no one size fits all solution. There are tensions and risks in any reward system and these need to be recognised and managed, for instance between the needs of the organisation to reward and recognise individual performance, but in such a way that it does not impact adversely on cohesion of the organisation and the achievement of longer term goals.
- while incentives may have contributed to the credit crunch on their own they did not create it, so their role should not be exaggerated, not what can be achieved by their reform. Performance and talent management are just as important components of successful reform of the cultures in these companies.
- managing risk more effectively is not just about more sophisticated risk-adjusted measures of performance and it is not just more complex

compensation plans, it is also about the wider performance management environment and culture of the organisation.

- many employers will already be using the FSA's good practice criteria at board level. The implementation of good practice criteria below board level, for highly paid talent needs to meet high standards of governance and design. Boards should ensure that this is happening
- employers need to look beyond reward and examine their people management strategy and practices to ensure it is creating or sustaining a culture supportive of long-term shareholder and business needs
- the involvement of reward professionals in the design and management of incentives is an important element in ensuring that they are designed to meet their aims, effectively modelled to identify costs and set within the context of wider people management. The reward function should be involved with the risk management, governance and finance functions when creating their remuneration practices
- organisations need to review the capability and skills of the HR function in such areas as risk management and finance so that it can play a role in training the non-executive directors while the compensation function needs to be properly resourced so it can play an influential and strategic role in reward management
- organisations need to review whether the remuneration committees and others associated with design and management of incentives have the sufficient capability to review the reward-risk issue
- organisations need to recognise the importance of good people management to organisational success and to regular monitor HR practices at board level

*January 2009*

## **Memorandum from The Financial Times Limited**

### **Introduction**

1. The Financial Times, one of the world's leading business news organisations, is recognised internationally for its authority, integrity and accuracy. Providing extensive news, comment and analysis, the newspaper is printed at 24 print sites across the globe and has a daily circulation of 448,523 (ABC figures, November 2008). The newspaper, consisting of separate UK, US, European, Asian and Middle East editions, was last year named "Newspaper of the Year" in three separate highly regarded awards ceremonies. The FT's writers are recognized experts and commentators in their respective fields and the various publications are frequently cited as authoritative sources by leaders in the financial sector.

FT.com is one of the world's leading business information websites providing an essential source of news, comment, data and analysis for the global business community. FT.com attracts 7.1 million unique users, generating 72 million page views per month (ABCe figures, March 2008).

The FT group of companies also includes fund management information provider Money-Media and Financial Times Business which produces specialist information on the retail, personal and institutional finance industries, including the UK's premier personal finance magazine Investors Chronicle, The Banker, Money Management and Financial Adviser for professional advisers.

2. The Treasury Committee is undertaking an inquiry into the Banking Crisis and has called for evidence from interested parties on a range of issues. At paragraph 1.11 of its request for evidence, the Committee has invited submissions on "The role of the media in financial stability and whether financial journalists should operate under any form of reporting restriction during banking crises".
3. The Financial Times Limited ("FT") is making this submission in response to that specific request at paragraph 1.11.

### **Executive Summary**

4. This submission raises the following issues:
  - (a) The media plays a crucial role in disseminating information regarding issues of public importance to the rest of society. The current global financial crisis and the bank failures that have contributed to it are issues of immense public interest and significant complexity. It is therefore the responsibility of the press to explain what has happened and what measures are being taken by government and financial institutions to address the current state of affairs so that members of the public may evaluate the actions taken by key decision makers and make informed decisions regarding their own circumstances.

- (b) By making information available to all members of the public simultaneously, i.e. greater transparency, the financial media actually act against the creation of false markets and contribute to the proper functioning of the financial system.
- (c) Reporting restrictions constitute a prior restraint on the right to freedom of expression and as such must respect the requirements of Article 10 of the European Convention on Human Rights. Given the indisputable public interest in the ongoing economic turmoil the FT is of the view that reporting restrictions in such circumstances could not be justified.
- (d) If there is concern regarding the quality or content of financial journalism in the UK, the government should more properly be assessing the degree of public disclosure required by financial institutions – including banks, private equity firms and hedge funds. We submit that focusing merely on the role of the media as opposed to addressing the overall sufficiency of disclosure obligations and public access to financial information misses the larger issue altogether.

Each of the above issues is elaborated in the main body of the submission.

### **The role of the media in financial stability**

- 5. This submission addresses only one of the key areas identified for consideration by the Committee as part of its inquiry, specifically paragraph 1.11, under the heading “Securing financial stability”, regarding “The role of the media in financial stability and whether financial journalists should operate under any form of reporting restrictions during banking crises.”
- 6. It will come as no surprise that the FT – along with other media organisations – is extremely concerned to learn that the government is even considering the possibility of imposing reporting restrictions on the financial media.
- 7. The UK authorities have repeatedly recognized the crucial role played by the media as “watchdog” protecting the public interest and also as the primary means of disseminating information regarding public life to the rest of society.<sup>1</sup> That the financial system is an integral part of public life and therefore a worthy subject matter for extensive media coverage should be totally uncontroversial.

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<sup>1</sup> For example, the House of Lords decision in *McCartan Turkington Breen v. Times Newspapers Ltd.*, [2001] 2 AC 277, at p.290, Lord Bingham of Cornhill states: In a modern, developed society it is only a small minority of citizens who can participate directly in the discussions and decisions which shape the public life of that society. The majority can participate only indirectly, by exercising their rights as citizens to vote, express their opinions, make representations to the authorities, form pressure groups and so on. But the majority cannot participate in the public life of their society in these ways if they are not alerted to and informed about matters which call or may call for consideration and action. It is very largely through the media, including of course the press, that they will be so alerted and informed.

8. The increasing complexity of global financial systems and the speed at which developments occur make it imperative that the media be able to report freely to the public regarding what is happening in their economy and ultimately, with their money. For instance, the decision made by governments around the world to commit unprecedented levels of tax payer money to rescue failing institutions requires a media that is capable of explaining the bail out packages in order to ensure that these receive the required degree of scrutiny. One cannot seriously maintain that the public interest – or financial stability – would be better served by keeping the public in the dark regarding a £50 billion bail out of UK banks, or not reporting why a stock price is moving up and down.
9. It is arguably naïve, in this era of email, blogging and instant messaging (much of it anonymous), to attribute the spread of false rumours to the media, or to accuse the media of aggravating the banking crisis – however defined. In fact, the media and financial regulators frequently have similar objectives, including dispelling unfounded rumours that distort the market, and regulators frequently benefit from the media’s efforts to hold the market’s participants to account.
10. An example is provided by the FT stories that revealed how mathematical models used by Moody’s to evaluate an important financial product contained a computer error that resulted in the product receiving a higher rating than it deserved (see <http://www.ft.com/cms/5fd271ee-61f6-11dc-bdf6-0000779fd2ac.html>). The stories were published after the FSA declined to investigate due to a lack of jurisdiction. As a direct result of the revelations, Moody’s initiated an external review of its practices and took steps to improve the integrity of its ratings processes. The Securities and Exchange Commission in the US announced an investigation into the affair and Standard & Poor’s – another of the dominant ratings agencies – publicly disclosed that an error had been found in one of its models. Each of these occurrences will or should improve how the ratings agencies function, to the benefit of the public, and were triggered by an investigation undertaken and reported by the media.
11. A further example of the important role played by the media throughout the current economic crisis is provided by the coverage given to the collapse of Lehman Brothers and the fall out from the uncovering of Bernard Madoff’s suspected billion dollar “Ponzi scheme”. Although two very different sets of circumstances, each involved countless numbers of small investors seeking and needing to obtain reliable, timely and accurate information in order to protect their interests as best as they could. If these investors had been obligated to rely only on the flow of information from the press office of Lehman’s administrators or Madoff’s prosecutors then they would effectively have been left entirely in the dark, if not misinformed.

## Arguments against reporting restrictions during banking crises – Article 10 issues

12. For the reasons set out above, namely the important role played by the media in informing the public regarding the financial sector, it is the FT's submission that there is no case for the imposition of reporting restrictions during banking crises. It is also the FT's submission that such restrictions would be difficult if not impossible to justify under Article 10 of the European Convention on Human Rights.
13. Both the UK courts and the European Court of Human Rights (ECHR) have held that reporting restrictions constitute an interference with the right to freedom of expression and that such restrictions will only be legitimate if they satisfy the Article 10 requirements.
14. One of the requirements is "necessity", i.e. there must be a "pressing social need" for the restriction. Furthermore, according to the ECHR, the test of necessity also requires a determination of whether a restriction "was proportionate to the legitimate aim pursued and whether the reasons given by the national authorities to justify it are relevant and sufficient."<sup>2</sup>
15. Sufficient recourse against media who report false and damaging, or true but confidential business information already exists in the form of plaintiff friendly libel laws and a strict confidentiality regime. There is also a system of self-regulation in place, overseen by the Press Complaints Commission, which provides recourse to members of the public, including companies, when the media has reported inaccurate information. The PCC Code of Practice also regulates the press to prevent insider dealing and market manipulation through self-disclosure requirements. Consequently, there is no need for additional restrictions.
16. The courts have, in fact, on at least two recent occasions heard cases arising from the bankruptcy of companies in total privacy, with even the judgments being withheld from the public for a period of time.<sup>3</sup> This practice is enormously problematic and further strengthens the argument that no additional obstacles to the dissemination of information are required. On the contrary, the government should be reviewing the scope of the courts' powers to exclude the public from hearings without even providing an opportunity for appeal.
17. A further requirement that any restriction on the right to freedom of expression must meet in order to be considered compliant with Article 10 is that it be "prescribed by law". As explained by the ECHR, "one of the requirements flowing from the expression "prescribed by law" is the foreseeability of the measure concerned. A norm cannot be regarded as a "law" unless it is formulated with sufficient precision to enable the citizen

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<sup>2</sup> *Feldek v. Slovakia*, 12 July 2001, Application No. 29032/95, at para.73. See also *Ibid.*, at p.290.

<sup>3</sup> *Re Whistlejacket Capital Ltd*, [2008] EWCA Civ 575 and *Re Sigma Finance Corporation (in receivership)*, Companies Court case 9750 of 2008, Court of Appeal 2008/2689 and 2707.

to regulate his conduct: he must be able - if need be with appropriate advice - to foresee, to a degree that is reasonable in the circumstances, the consequences which a given action may entail. Those consequences need not be foreseeable with absolute certainty: experience shows this to be unattainable. Whilst certainty in the law is highly desirable, it may bring in its train excessive rigidity and the law must be able to keep pace with changing circumstances. Accordingly, many laws are inevitably couched in terms which, to a greater or lesser extent, are vague and whose interpretation and application are questions of practice.”

18. It is the FT’s submission that the attempt to define what constitutes a “banking crisis” and when a crisis exists, for the purposes of imposing reporting restrictions, will necessarily be problematic and will not be possible with the degree of precision required by Article 10. Any move by a court to impose a reporting restriction because of a deemed “banking crisis” is actually likely to create more panic than it would avert.
19. The ECHR has repeatedly stated that any form of prior restraint on freedom of expression, which includes reporting restrictions, “call for the most careful scrutiny on the part of the Court”<sup>4</sup> and that “there is little scope under Article 10(2) of the Convention for restrictions on political speech or on the debate of questions of public interest.”<sup>5</sup> The public interest in banking crises is significant and indisputable.
20. Transparency is the best means for ensuring fair, balanced and accurate reporting. The value of public access to information on matters in the political sphere has been recognized internationally through the adoption of freedom of information legislation. Many of the same rationales – including the building of trust and accountability – exist for increasing the transparency of financial institutions. Consequently there is growing pressure in many jurisdictions is towards greater disclosure.<sup>6</sup> Any move by the government to increase regulation of the media through the imposition of reporting restrictions would be retrograde and, the FT submits, a violation of the UK government’s legal obligations.  
December 2008

### **Memorandum from the National Union of Journalists**

1 The National Union of Journalists represents 37,000 professional journalists in Britain and Ireland. Our response to this inquiry focuses on one paragraph in the call for evidence:

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<sup>4</sup> *The Observer and Guardian v. the United Kingdom*, 26 November 1991, Application No. 12585/88, at paragraph 60 (the “Spycatcher” case).

<sup>5</sup> *Wingrove v. the United Kingdom*, 25 November 1996, Application No. 17419/90, at paragraph 58.

<sup>6</sup> For instance, efforts are being made by regulators and parts of the hedge fund and private equity sectors to increase transparency. This month the G20 called for a unified code of practice for hedge funds. The European Commission is due to present proposals for hedge fund and private equity oversight next month. And in the US, Hank Paulson, Treasury secretary, is reported to have reversed his opposition to regulating the hedge fund industry.

1.11 The role of the media in financial stability and whether financial journalists should operate under any form of reporting restrictions during banking crises.

2 It is always vital that media have the right to inform the public of matters of serious concern. The notion that movements in financial markets have been consequent on media reports is mistaken and misconceived.

3 Operators in the markets know much more about their workings than any journalist. The whole section of the market trading in derivatives is based precisely on this knowledge. Journalists are passing to the public information on the basis of which millions of pounds are already moving on the market.

4 If a bank collapses the day after a BBC economics reporter reports that it is in trouble, that is because the bank is in trouble, not because of the report. The NUJ does perceive an element of “shoot the messenger” in proposals to apply restrictions to financial reporting.

5 There is a crucial role for business and financial journalists in holding the world of high finance to account. The entire population, at some level, has a direct interest in the performance of financial institutions, and they are entitled to know how they are performing.

6 Indeed it has been argued that media did not scrutinise them enough. A recent article by the respected commentator Will Hutton said that journalists did play some part in the financial crisis by failing to apply the same rigour to business reporting as to other areas.

7 Journalists had failed to assess how the wealth was being made, he said. “We suspended our judgement and we are paying a big, big price.” Reporters had been guilty of accepting what the business community told them, in a way that would not happen when reporting on other issues.

8 The full article can be found at:  
<http://www.guardian.co.uk/media/2008/nov/21/events-pressandpublishing>

9 The media might also have been said to contribute by helping to whip up Britain’s mountain of debt by encouraging reckless spending and the inflation of property prices.

10 Considerably more damage was probably done that way than by any reporting of banks running into financial trouble, but nobody is proposing restrictions on the reporting of consumerism.

11 No restrictions on reporting during financial crises will bring any benefit, since the crisis will continue anyway, and will do great harm in preventing the public having the information about it that they need.

12 If policy makers are concerned about maintaining trust in the banking system, nothing could be more dangerous than to introduce the potential for

consumers to believe that information known widely in the city is being kept from them. It is the banking system that should be examined, not how it is reported.

13 Opaque systems that nobody could understand played a key part in the current financial crisis – so if anything greater transparency is needed.

*December 2008*

## Memorandum from Odey Asset Management

1. The Treasury Committee is seeking to identify the lessons that can be learned from the banking crisis. Odey Asset Management is glad to have the opportunity to contribute to this work.
2. In Annexe 1 of this letter we respond to the list of issues raised by the Committee.
3. But there are wider issues, and we have thoughts to offer which do not fit within the Committee's specific list of questions, but which we believe go to the heart of the matter. Our view of these issues is key to our investment work, and has allowed us to protect the savings and pensions of our investors in these difficult times. They are:
  - that the Committee should additionally address itself to the preparation of a policy response to the forthcoming second wave of the banking crisis
  - that the underlying problem has been the accumulation by households, companies and governments, largely since 2001, of unsustainable levels of debt
  - that a managed restructuring of the UK and global debt burden is the necessary precondition for restarting economic growth.
4. But before addressing these points in more detail, we should first introduce ourselves, declaring our expertise and interests.

### About ourselves

5. Odey Asset Management is an investment management house with some (£2.6bn/\$4bn) under management, authorised and regulated in the United Kingdom.
6. We seek to protect the capital of our investors, be they pension holders or private investors, and to deliver absolute returns when we can. We follow a cautious and common sense approach. Key to our work is the thinking we put into the positions we take, examples of which have been our refusal to participate in the late 1990's dot com bubble judging that it was a boom without foundation, or the decision two years ago to take investments out of the financial and property sectors because they appeared to us to be built on the weakest of foundations. We make simple and uncomplicated investments in shares, debt, and currencies, and make minimum use of derivatives. We do not use large levels of borrowing/leverage. Our investors are not subject to "lock-ins". And we are transparent to our investors and regulators. As we value transparency ourselves, and as we believe it essential to have a clear view of a company if we are to invest in it, we expect investors to have the same requirement of us if they are to let us manage their savings.
7. Founded 17 years ago, we have a number of funds of different types which we run across the world, some are simple investment accounts, and a minority are absolute return funds, currently called hedge funds although they

were founded before that term came to mean what it does today. Our flagship absolute return fund has delivered compound annual returns of 15% a year over 17 years, although with very significant periods of either out-performing, or being out-performed by, stock market indexes on the way. We do not invest to follow the market, and our clients offer us their money to manage on that basis.

8. The remuneration of our staff is heavily dependent on increases in the value of the fund. If the funds we manage on behalf of the investors do not perform then we do not receive performance fees. Also, we expect our fund managers and principals to have their own money invested in our funds – so that they share the same risks as the other investors.

### **Our view**

9. We wish to bring to the attention of Committee Members that the phrasing of their list of issues sometimes pre-supposes that ‘the banking crisis’ is behind us. We are not of that view. The first phase of the crisis was that the banks stopped lending to each other. This mutual and total loss of confidence within the banking community was unheard of in this generation. It caused a global credit crisis. That crisis and first phase is now receding, and thanks are in order to the world’s governments for swift and significant action to address the problem.

10. But there is a second phase of the crisis ahead of us. This will be a more ‘familiar’ banking crisis caused by the recession, in which the economic downturn triggers the bankruptcy and default on loans of companies and households, causing banks to lose money and exhaust reserves. With a hard recession ahead, bank reserves are insufficient. We – unfortunately – hold the opinion that certain key banks in the UK will need significant further capitalisation, that this is unlikely to be forthcoming from the markets, and that the Committee should therefore additionally address itself to the preparation of a policy response to the forthcoming second wave of the banking crisis.

11. Public statements across all parties have tended to address the question of “how to solve the banking crisis?” as if unfreezing the system would allow the economy to return to the norms of the last twenty-five years. The failures of the financial system must be addressed, and we have to put in place measures to stop this foreseeable and foreseen demolition of wealth and invested savings from repeating. But the troubles of the banking sector are not the cause, although they are at the centre, of the crisis. They are a symptom and multiplier of the underlying problem. The underlying problem has been the accumulation by households, companies and governments, largely since 2001, of unsustainable levels of debt (Fig 1.) If not managed down, debt will prevent recovery.

12. Churchill liked to ask what was the tremendous fact of a situation? The answer this time, is “debt”. The social costs of leaving the markets to deal with this debt are unacceptable. Addressing the symptoms provides respite and help to keep the economy functioning, but it offers no solution - for debt endures. What is to be done is the discovery and implementation of **measures to bring**

**debt down to a level at which economic growth can re-start.** In January 2005 we commissioned a study by Edward Chancellor called “Crunch Time for Credit” (Intelligent Investor Special Report) to investigate in a dispassionate way what we believed then was an “unsustainable trend”. Unfortunately the crisis was not averted. But now that it is here, we are hopeful that lessons can and will be learnt - and that a better path will be laid for the future.

13. It is our view that a managed restructuring of the UK and global debt burden is the necessary precondition for restarting economic growth, for markets in housing and banking finding a floor from which to rebuild, and for the steady rebuilding of savings sufficient to guarantee pensions, investment, and innovation in the long term.

14. As investment practitioners who to an extent foresaw the financial crisis before it arrived, and mindful of the responsibility we carry to the investors and savers whose money we manage, it seems right and necessary to engage positively, and on an all-party basis, with this important policy and social debate. We are grateful to the Committee for giving us the opportunity.

Annexe 1: Response to Treasury Committee list of issues

**Annexe 1: Response to Treasury Committee list of issues,  
from Odey Asset Management**

**ISSUE 1.3:  
THE ROLE, AND REGULATION, OF HEDGE FUNDS IN THE BANKING CRISIS,  
AND WHETHER ANY REFORMS ARE DESIRABLE.**

**AND**

**ISSUE 1.10:  
RISKS TO FINANCIAL STABILITY EMANATING FROM NON-BANK FINANCIAL  
INSTITUTIONS.**

After years of concern which focused on the ‘hedge fund’ industry, the banking crisis was triggered by the banks themselves – the most heavily regulated part of the financial services industry. The main conclusion is that regulation must get the core right. And that means the banks.

We would like to bring to the Committee’s attention **the difference between the fund manager (the people and the firm) and the fund (the money to be invested)**. The money, “the fund” is inanimate and should be subject to money laundering and auditing rules. It is the fund manager who must be regulated. We do not see merit in regulating funds beyond audit and accounting norms.

**Regulation of Investment Managers:** we advocate transparent markets and transparent financial organisations to protect investors, together with strong

international accountancy standards. We do not have confidence in unregulated fund managers, and point out that the alleged Madoff criminal fraud would be significantly less possible in the UK, primarily because we believe that the UK's regulator, the FSA, would require any significant investment firm to use a major independent accountancy firm.

Proposal:

- All fund managers and investment firms globally to be brought under internationally validated regulatory regimes
- All investment managers – of whatever type – to provide regular reporting of their investment positions to their regulating body, and at a lower level of granularity for their investors. This information could be passed in aggregate to international bodies for coordination of international economic policy. The objective could be achieved through a coordinated requirement announced by global regulatory authorities
- All investment managers subscribing to recognised regulatory regimes should see the level playing-field extended to permit them to offer services to retail investors

**Framework for a regulatory structure for the financial services industry:**

we would like the Committee to consider a three-way division of the regulatory structure.

The prime systemic risk from banks is to their depositors. So the focus of regulation here is about depositor protection and bank finance. Therefore we would move to a regime where deposit taking banks are regulated as utilities which cannot fail. The UK has great experience of this in other sectors.

The prime systemic risk from other financial actors is to markets. The focus here is on stopping market abuse and ensuring that markets are working. This type of regulation allows companies to fail, as it will allow companies, entrepreneurs and innovators to reap the rewards of success. It requires different regulatory skills from 'utility banks' above. This is the sector which will grow and which will be core to the future success of the City of London. Providing markets are not being abused, and the City Regulators have much expertise and experience of this, and were rules brought in to limit the leverage allowed to firms licensed to operate in this area to levels below those allowed to the banks, then systemic risk will be managed down to acceptable levels.

Consumer and investor protection underpins both groups. Here the focus is the ombudsman role, and enforcement of agreed accounting standards, with particular attention given to ending off-balance sheet accounting. We would advocate the creation of a separate investors and savers protection body in the UK.

London's star attraction as a financial centre is the agglomeration in one location of expertise, a favourable tax regime, institutional order and a fair regulatory regime. We do not believe that the regulatory failures which allowed the recent Volkswagen debacle could have happened in the UK.

Proposal:

Three way division of the regulatory structure for the financial sector:

- deposit taking banks regulated as utilities which cannot fail
- other financial players regulated to protect markets, and allowed to fail
- creation of an independent investor and saver protection body and Ombudsman

#### **ISSUE 1.6:**

#### **POSSIBLE REFORMS TO THE REMUNERATION STRUCTURES PREVALENT IN FINANCIAL SERVICES.**

As practitioners we want to be able to reward our staff for performance over time. This is made harder by current HMG taxation policy meaning that we cannot efficiently set aside payments across multiple years contingent on performance. We have had to develop a form of share scheme to achieve this.

Proposal

- A change to taxation treatment of performance pay within company accounts, to facilitate companies setting aside remuneration contingent on multi-year performance
- Investment management firms to receive fees based on multi-year performance
- Individual fund managers to be required to invest 25-50 per cent of their personal financial assets in the funds they manage

#### **ISSUE 1.7:**

#### **REFORMS TO REGULATORY CAPITAL AND LIQUIDITY REQUIREMENTS.**

To be effective, principles and rules must be transparent to investors and regulators alike, and easily understood. Recent history shows the result of abandoning these principles.

Since 1999 the Tier 1 equity to total assets ratio of the domestic banks (ratio showing how heavily they borrow) began to fall from its long-term historic ratio of around 4 per cent, to around 2 per cent by 2007 (Fig. 2). This signalled that the banks were over-extended and taking historic risks, and the change helped

create the crucial £700bn gap between loans and deposits in the UK banking system.

In parallel the more subjective, complex, and less transparent measure referred to as “risk-weighted assets” remained stable at 5 per cent, masking the fundamental change. Also, in 2005 the introduction of IFRS accounting standards stopped banks from making “rainy day” provisions against unforeseen future problems. Spain was the only European country not to make the change, allowing Spanish banks to begin this recession with a greater buffer (whatever other issues they may have).

Hidden behind the scenes, bank assets were shifted from their balance sheets to vehicles with less stringent capital rules – allowing banks to borrow even more without investors able to see - regulators and banks too readily believed the risk had been transferred away.

Proposal:

- Restrict the debt/leverage which deposit-taking banks are permitted to use, including a cast iron total tier 1 equity to asset ratio of 3-4 per cent
- If assets are moved off balance sheet the risk must be fully transferred away, and to do this the regulatory capital deductions preventing “double leverage” must be consistently applied (double leverage occurs when a bank holds an asset which itself is underpinning significant debt)

- The risk weighting regime should be retained alongside the measures above, but the constituent parts must be made simple and visible to regulators and all stakeholders. When mortgages are dealt with, the risk weighting must take into account the debt/income ratio of the individual borrower – thus making transparent to all a key determinant of the quality of the mortgages
- Simplify Basle II, encourage consistent definitions of bank assets across IFRS and US GAAP accounting rules, and counter-cyclical provisioning

**ISSUE 1.14:  
THE IMPACT OF SHORT-SELLING IN THE BANKING CRISIS AND ITS  
REGULATION.**

Short selling gives markets stability, liquidity and robustness. And recent months have also demonstrated how fragile financial markets can be, and how dangerous that situation is for the real economy.

The crucial stock market falls have taken place after global short-selling bans were imposed, so we have seen that banning short selling does not stop markets falling.

It is worth noting that to sell (or short) a stock there has to be a buyer on the other side of the trade. There is sometimes the perception that a covered short position is more open to market abuse than a “normal” long position. This is not true, for both are normal parts of investment business.

Proposal:

- That the short selling ban be ended in the UK, as it has been in the USA.
- The Committee might consider whether the practice called “naked short selling” be banned, for it is this which can be de-stabilising and can leave investors exposed to outlandish risk. Any investor selling a share should have legal entitlement to it, either because they own it or because they have a right to it as a “covered” short sell
- That new short positions be banned during a rights issue, to avoid any risk of destabilizing the market at a vital and sensitive time for a company
- Greater disclosure could also be achieved by a global requirement that all regulated firms should inform their regulator of short positions they hold over 0.25% of shares outstanding in a company and from whom have they obtained the ‘title to sell’. A percentage threshold which follows the precedent set by rules for rights issues

## Conclusion

We believe that administrations bringing in regulations along these lines will find support amongst investment practitioners, investors and savers. Much of the above is about making current best practice the norm, about outlawing unacceptable worst practice, and about ensuring that regulation is taken forward so that it favours a strong and successful financial services market as a necessary foundation for the real economy through the difficult economic times which lie ahead.

Policy responses to the current crisis will require careful phasing-in, avoiding sudden changes which would be harmful to the fragile state we are in.

Fig. 1: Total debt (household + corporate + Govt.) by country/zone as % of GDP

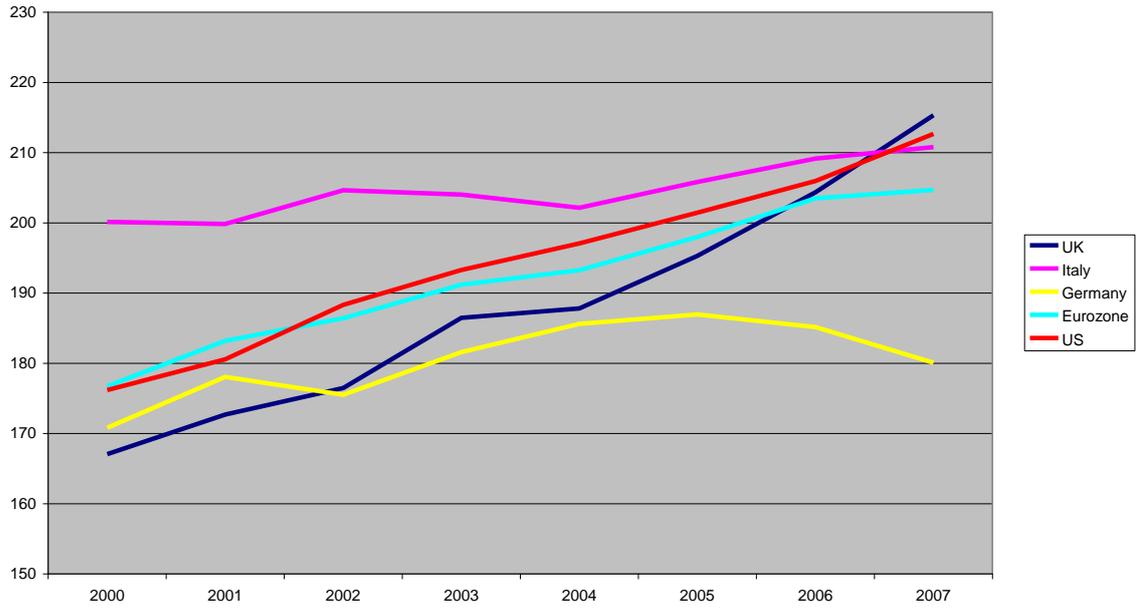
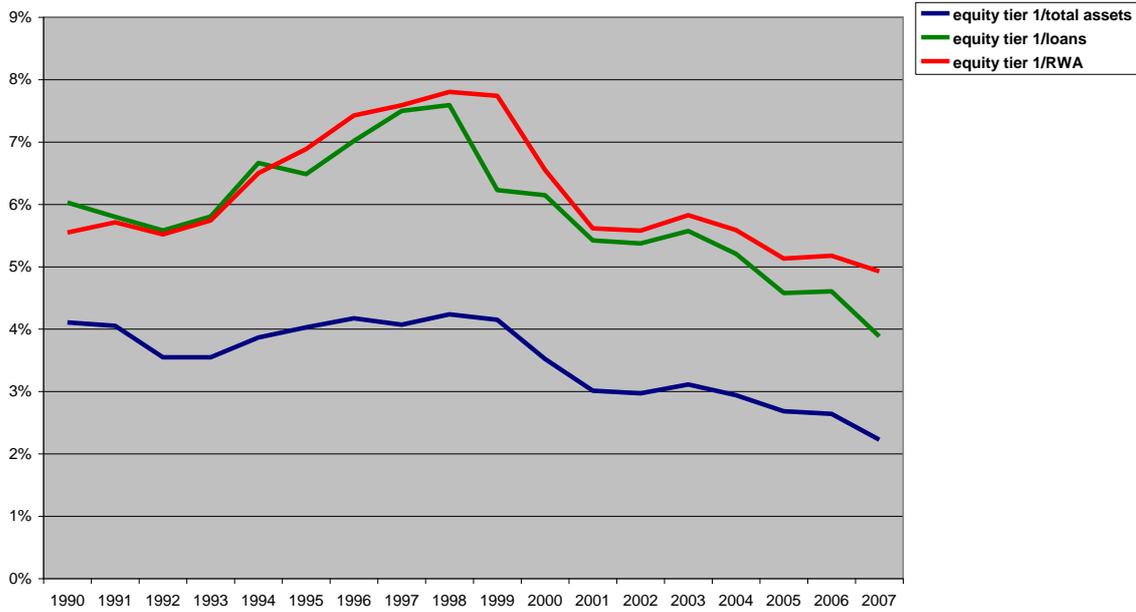


Fig. 2: UK bank debt ratios: equity Tier 1 ratio to total assets, to loans, and to risk weighted assets (RWA) (OAM rebalanced assets)



January 2009

## **Memorandum From Shelter**

### **SUMMARY**

1. We welcome the Committee's decision to examine the lessons that can be learned from the banking crisis and the opportunity to contribute to the inquiry. Our submission focuses on the need to reform mortgage law to protect people at risk of repossession, and on regulation of mortgage lending.
2. With the CML predicting 75,000 repossessions in 2009, it is vulnerable homeowners and tenants who are likely to be the real victims of this period of economic turbulence.
3. It is crucial that we take this opportunity to reform the law of mortgages so that we can better protect people who are at risk of losing their homes and at the very least minimise the disruption and trauma that repossession entails.
4. Shelter would like to see reform to the law of mortgages to give courts more power, and greater protection for tenants whose landlords are at risk of repossession.
5. Furthermore in terms of regulation of mortgage lending, this has only been regulated by the Financial Services Authority (FSA) since 2004; Shelter believes that this relatively new system of regulation and scrutiny still has some room for improvement.
6. The Mortgage Conduct of Business (MCOB) offers some degree of protection to consumers but the regulations are not very well enforced, nor do they go far enough.
7. The FSA is not a very transparent or consumer-focused organisation. We would welcome more external clarity on enforcement actions and the protections available to consumers.

### **Government initiatives**

8. We welcome the Prime Minister's recent announcement of the Homeowner Mortgage Support Scheme, as well as other measures in the PBR, which will provide more help for vulnerable homeowners. However, as not all people at risk of repossession will benefit from these new measures it is still vital to ensure that those who face repossession are dealt with as fairly as possible, by lenders and the legal system.
9. We also welcome the introduction of the Mortgage Arrears Pre-Action Protocol. However, this Protocol is more a set of good practice guidelines than it is an enforceable set of rules because courts under current law have limited discretion and do not have the power to oblige lenders to use possession as a last resort.

## **Reform to the law of mortgages**

10. The law of mortgages is rooted in common law and has its origins in the 18th and 19th centuries. Broad reform to create a proper legal framework, fit for the 21st century, is long overdue. For example, lenders do not have to obtain an order from the court if they wish to repossess and then sell the home of a customer in default. Lenders can take possession of mortgaged property without the assistance of a court unless they have agreed otherwise in the mortgage deed.

11. A recent High Court ruling supported a decision by lender GMAC-RFC to sell the property of a borrower who was in arrears. The ruling confirmed that if a borrower falls two months into arrears, mortgage lenders can sell up without a court repossession order. The Ministry of Justice is currently considering the implications of this judgement and whether further action is needed.

12. Even when cases do make it to court, the fact that the law is based on the mortgage contract and is subject only to limited statutory controls means that it is weighted in favour of the lender and the court has only limited powers to intervene. Shelter believes that courts should have a similar discretion to that which they exercise with secure and assured tenancies, to make whatever order is reasonable in the circumstances of the case.

13. Shelter also believes that it is unnecessary and unfair for lenders to retain the right to use foreclosure, which extinguishes the borrower's equity of redemption, so that the lender keeps the entire proceeds of sale. Furthermore, allowing lenders to charge to the borrower their legal costs without being obliged to ask the court for an order to do so, means that large sums are added to the mortgage debt with little or no scrutiny as to whether the amounts are fair or proportionate. We see no rational justification for lenders not to be subject to the same rules as other litigants, who can only charge costs if the court has made an order for costs in their favour.

## **Tenants and repossession**

14. Shelter is concerned about the rights of tenants who live in properties that are under threat of repossession. As tenants are not named in possession claims and are not necessarily given the opportunity to see the possession order, they can be left with just a couple of days' notice before possession is taken. They have to vacate the property immediately, and if they do not they are treated as trespassers and evicted by the bailiffs.

15. This irrational and unjust situation causes great distress for many of Shelter's clients, particularly those with children. It makes no sense to treat tenants as trespassers, particularly in terms of the prevention of homelessness agenda. We would like courts to have the discretion to defer possession for up to 90 days to give the tenants a chance to find somewhere else to live. We have good reason to believe that the judiciary would warmly welcome this reform,

since district judges in county courts are often unable to make the kind of order that they would wish to make in these situations.

### **Regulation of mortgage lending - monitoring and enforcement**

16. Shelter believes that there are flaws in the way that mortgage regulations are monitored and enforced, and we have particular concerns about the effectiveness of the regulatory regime within the sub-prime sector.

17. The FSA's own investigations, backed up by Shelter's experience in our advice centres, have shown significant gaps in arrears management practice. This is particularly the case among intermediaries in the sub-prime sector, who are not always thorough and responsible in their sales and marketing when it comes to checking that products are affordable and/or suitable for customers.

18. Among this group, the FSA found that in one third of cases investigated there had been no adequate assessment of affordability. In one-half of the cases surveyed, no adequate assessment of the suitability of the product for the customer's needs had been carried out. None of the lenders surveyed had covered all responsible lending considerations in their policies.

19. In August 2008, the FSA completed a review of 18 lending firms' responsible lending policies and 250 firms' mortgage advice. Both areas were found to have serious weaknesses.

20. The usual result of an enforcement action is a fine and an agreement sought that the company will review its business practices, or in some cases the company will agree not to continue the practice any more. However, fines are often negligible when compared to the company turnover. Shelter does not believe that the penalties for misconduct are stringent enough.

21. We recognise that the FSA has been able to identify some of the problems with enforcement, but we are concerned that they have been apparently unable to improve the situation. If this is due to lack of resource then this is something that the Treasury should address urgently.

### **The mortgage conduct of business (MCOB)**

22. The problem of weak enforcement of regulations is compounded by weaknesses in the regulatory framework itself. The FSA's approach to regulation is 'principles based', giving firms a flexible, rather than prescriptive remit.

23. Much of the language used in MCOB is vague and open to interpretation. Terms such as 'fairly' and 'reasonably' are frequently used without clear definition. This gives lenders the ability to define those words in a way that suits them. Shelter believes that the FSA should revise the language and make it more prescriptive.

24. Shelter is awaiting the results of the FSA review of arrears management. The review does not have a fixed timetable but has now been ongoing for some time. We urge the FSA to outline a clear and expedient timetable for the conclusion of the review.

25. MCOB allows for self-certification of income 'where appropriate' and says that lenders should find 'no reasonable grounds for doubting the information provided'. The review should look at how lenders interpret this in practice and definitions of 'appropriate', as lenders currently have quite a lot of leeway on this.

26. The rules could also be clearer on defining ability to repay. At the moment, the FSA 'would expect' lenders to take certain factors into account (such as the impact of coming off an introductory or short term rate, or the ability to repay from sources other than income). This could be strengthened: irregularity of income, impact of retirement and other long-term issues should also be considerations.

27. Some lenders impose unreasonable default charges on their customers, which just add more and more debt and are particularly unfair if a repayment plan has been negotiated. For example, some will charge fees for every letter or call regarding arrears. Shelter believes that MCOB should explicitly state that it is unreasonable to continue to add default charges when the borrower has agreed a new repayment plan with the lender and is keeping up with this plan.

### **Lack of transparency and consumer focus**

28. The fact that MCOB does not require lenders to publish their arrears policies makes it difficult to challenge them in possession cases. The FSA should require lenders to publish their policies.

29. There should also be greater transparency about the enforcement process, which often happens behind closed doors. It would give consumers and stakeholders more confidence to know more about enforcement action when it is taken.

30. The FSA should be reformed so that it has a more consumer-focused approach. For example, the FSA Board is mainly comprised of industry representatives, and could include more consumer spokespeople.

31. As mentioned earlier, there has been very little external clarity or stakeholder engagement around the current review of arrears management.

32. The dual system whereby second charge and buy-to-let loans are regulated by the OFT causes confusion for consumers, for whom there is very little clarity about what protection is available. This would be improved if the FSA were responsible for regulating all loans secured against residential property.

*January 2009*

## Memorandum from David H Smith

### Executive Summary

*In what follows T.O.R. means 'term of reference'.*

#### **Section 1: (T.O.R. 1.9 Regulation of highly complex financial products, and the future of the “originate-to-distribute model”).**

1. As I am sure the committee already recognises, the “originate-to-distribute model” has been an essential feature in the banking crisis. Measures to control the spread of risk throughout the financial system will be essential in the prevention of future crises. It is not realistic to expect any regulator adequately to control the aggregate amount of risk in the financial system, by regulating and/or monitoring the risk management arrangements of individual banks or other financial institutions.[paras 9 to 14]
2. If all ‘over the counter’ derivatives trading were banned, so that all such trading were carried out on regulated exchanges, the level of risk taken by banks and other financial institutions would be better understood by its traders, rating agencies, potential creditors, investment analysts and regulators. Governments could signal well in advance which banks would not be supported if they got into difficulties.[paras 15 to 18]
3. It is difficult to see any public interest in allowing banks, or indeed any quoted company to control Special Investment Vehicles that are registered in tax havens and/or are ‘off balance sheet’. [paras 19 to 21]
4. International agreement should be sought for such measures. Failing that, HMG should consider acting unilaterally.[para 22]
5. Continued lobbying against such restraints should be expected from the financial sector, and therefore other measures are needed to bolster up the resolve of governments to control the financial system adequately.[paras 24 to 23]

#### **Section 2: (T.O.R. 1.12 Monitoring and surveillance of financial stability problems by the public sector.)**

6. Asset bubbles have become a regular feature of the global economy since domestic financial systems and international capital flows have been liberalised.[para 24]
7. National and supra national bodies should be established in order to forecast or recognise at an early stage, the onset of such bubbles. Such bodies need to be at arm’s length from the political process.[paras 25 to 27]

#### **Section 3: (T.O.R. 1.13 The role of the banking system within the overall economy.)**

8. In order to shift the emphasis in banking from making money out of money, to helping the real economy, the committee may wish to stimulate debate on monetary reform (a.k.a. seigniorage reform), and perhaps to conduct its own investigation into the subject.[paras 28 to 30]

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**Section 1: (T.O.R. 1.9 Regulation of highly complex financial products, and the future of the “originate-to-distribute model”).**

9. The causes of the Credit Crunch were:

Inappropriate Mortgage Terms for sub-primes, including, low introductory interest rates (but variable rates thereafter), no deposit, and relaxed income and creditworthiness requirements.

(Other) Asset Based Securities: Securities based on other types of loan, such as, Home Equity (2<sup>nd</sup> Mortgages), Car loans, Credit Card receivables, and student loans, have also been created and traded.

The originate-to-distribute model, whereby the financial risks are transferred to those banks that buy up the mortgages (and other loans), and hence retrospectively fund them. *Without the ability to pass on the risks, the mortgage lenders could not possibly have advanced more than a tiny fraction of unsound mortgages. The very existence of mechanisms to pass on the risk creates moral hazard.*

10. The main trigger of the sub prime crisis was probably a rise in interest rates. For example, the Federal Funds Rate climbed from a 40 year low of 1% in 2004 to over 5% in 2007. Admittedly 5% is not unusually high - it had been over 6% in 2000-2001 - but the low coincided with a huge surge in sub prime loans. The sub prime mortgages were variable rate, and often interest only - whereas traditionally, US mortgages have tended to be fixed rate. It is hardly surprising then that increased interest rates caused an increase in the rate of defaults and a fall in house prices. The fall in prices encouraged further defaults, and increased the losses to bankers on foreclosure. A vicious downward spiral ensued. Some of the other classes of loan may not have suffered initially, but may be expected to do so as unemployment rises. Another factor that may have contributed was the unfortunate timing of the introduction in September 2006 of ‘fair value accounting’ by the US Financial Accounting Standards Board. This does not mean that the reform was wrong; simply that things might have been different if it had been introduced two or three years earlier.

11. Fanny Mae and Freddy Mac played a part in spreading the risk, but increasingly they were bypassed as being too conservative [see for example the Written Statement of Fanny Mae CEO, Daniel Mudd, to the House of Representatives Oversight and Government Reform Committee, dated 9 December 2008.]

12. The collapse of the US housing bubble could have been foreseen. Concerns were raised in 1999 when Fannie Mae, responded to increasing pressure from the Clinton Administration to expand mortgage loans among low and moderate income people and pressure from stock holders to maintain its phenomenal growth in profits. Another Savings and Loan crisis was forecast. [Steven A. Holmes, 'Fannie Mae Eases Credit To Aid Mortgage Lending', New York Times, September 30, 1999]. Since then commercial banks have been prepared to take on risks that Fanny Mae would not. The fact is that such warnings were not heeded, and unless something is done, history suggests that the next bubble that could threaten the global financial system will not be anticipated.

13. If the bursting of the housing bubble could have been foreseen, why did the banks not foresee it? Why did they expose themselves so much? There are a number of reasons:

- It is almost impossible to assess properly the risk associated with a complex derivative such as a Collateralised Debt Obligation (CDO). The amount of information you would have to read is just too great.
- Mathematical risk models tend to assume that risks are uncorrelated, which has certainly not been true with mortgage backed securities.
- Banks' risk assessments would not have anticipated the systemic risk arising from the fact that banks might be unwilling to lend to each other.

14. Warren Buffett says that in any large financial organisation, the CEO has to be the chief risk officer. If the investors have to rely on the judgement of the CEO, how can any regulator be expected to do better? Acting at the level of individual organisations, regulators can only pick up the pieces afterwards. Regulation has to operate at different levels.

15. The use of complex derivatives such as CDOs has been an essential feature of the credit crunch. As mentioned above, their complexity has made adequate risk assessment impossible, and I suspect this has led to systematic underestimation of risk. Can they be banned?

16. The trouble about banning specific derivative securities, is that traders are endlessly inventive. They would stay ahead of the game. The alternative is to allow only specific types of derivative. The most satisfactory way of doing this would be to ban all 'over the counter' (OTC) - that is unregulated - trading, and require all derivatives trading to be on a regulated exchange. This would have several advantages:

- By setting up a system of 'margin calls', exchanges ensure that the chances of one party defaulting would be much reduced.
- Exchanges would publish information on the prices at which derivatives are traded, and the volume of trading. Regulatory authorities would have a much better idea of what was going on. Traders could be required to report their positions on the basis of the exchange prices. Where there is insufficient depth of trade to establish a reliable price, the exchange could be required to report a pessimistic figure.

- Because it takes time to implement new exchange traded products, regulatory authorities would have time to understand the new products and take any appropriate action before trading started. It would be rational, for example, to limit mortgage backed securities to the simple 'pass through' kind, banning the more complex CDOs - thus avoiding the difficulty in evaluating the security properly.

17. One issue that would have to be dealt with is how to define the term 'derivative'. If the definition were too narrow, new securities would be created that did not fall within the definition. One textbook definition is, "A derivative or derivative security is a financial instrument whose value depends on the values of other, more basic, variables." This definition is very wide and includes such things as traditional insurance policies and betting on horses. Nevertheless, I believe that this wider definition should be used, subject to a list of exceptions.

18. If all 'over the counter' derivatives trading were banned, so that all such trading were carried out on regulated exchanges, the level of risk taken by banks and other financial institutions would be better understood by its traders, rating agencies, potential creditors, investment analysts and regulators. Governments could signal well in advance which banks would not be supported if they got into difficulties.

19. One feature of this particular bubble has been that that the derivatives trading was formally carried out not by the banks themselves but by 'off balance sheet' Structured Investment Vehicles (SIVs) that they established. There are at least two reasons for this, to avoid regulation, and to avoid tax by registering the SIVs offshore. The SIVs were very highly leveraged.

20. The lethal combination of OTC derivatives and off balance sheet entities had caused trouble before. It was a major feature of the collapse of Enron in 2001. One might have thought that subsequent legislation would have outlawed these entities. However the US Sarbanes-Oxley Act of 2002, also known as Sarbox, fails to do this, but instead merely focuses on reporting and auditing requirements.

21. It is difficult to see any public interest in allowing banks, or indeed any quoted company to control Special Investment Vehicles that are registered in tax havens and/or are 'off balance sheet'.

22. International agreement should be sought for such measures. Failing that, HMG should consider acting unilaterally.

23. Nevertheless, strong lobbying to stave off or abolish effective regulation is bound to continue. Defence in depth is therefore necessary. It is essential that in future, asset bubbles be recognised early on. Hopefully further sub prime mortgage bubbles will not occur for some time, but doubtless other types of bubble will. Future asset bubbles may not be based on mortgages. There was for example the dot com bubble of 1995 - 2001.

## **Section 2: (T.O.R. 1.12 Monitoring and surveillance of financial stability problems by the public sector.)**

24. In its 2001 Annual report the Bank for International Settlements said: 'Financial factors have long played a role in shaping business cycles. However as domestic financial systems and international capital flows have been liberalized, this role has grown. Developments in credit and asset markets are having a more profound effect on the dynamics of the typical business cycle than was the case a few decades ago, and have also contributed to the increased frequency of banking system crises.'

25. With the further sophistication and depth of derivatives trading since the 1990s dot com bubble, the consequences of another such bubble in the future could be as catastrophic as those of the sub prime mortgage crisis.

26. I have argued that the sub prime mortgage crisis could have been anticipated. I believe the dot com bubble could also have been anticipated. The strategy followed by the dot com companies was to go for growth and accept losses until they achieved a monopoly, at which point they could make large profits. Whilst such a strategy was not entirely illogical for investors in a particular company, it ought to have been obvious that not all the companies could achieve their goal.

27. The smart strategy for investors in such conditions is to ride the bubble and get off just in time. These investors are not the right people to call for restraint. There should be appropriate bodies at national and supra national level charged with forecasting bubbles, or at least recognising them at an early stage. Once a growing bubble has been identified, investors could be warned, derivatives trading could be limited, and where the bubble is in part due to the policy of a government, that government could perhaps be persuaded to desist. Such bodies should be insulated from the political process in the same way that the MPC already is.

## **Section 3: (T.O.R. 1.13 The role of the banking system within the overall economy.)**

28. Although bankers and other financiers have been largely responsible for our current troubles, we are still in their hands. They have enormous power. Have they generally used this power for the public good? Should they be allowed to retain it?

29. One of the main reasons they wield so much power is the fact that commercial banks create 97% of the money in circulation in the form of credit in exchange for interest bearing debt. This compares with about 60% at the end of World War 2. Just 3% of the money stock is created by the Bank of England, at the behest of government, in the form of banknotes. There is no reason in principle why the Bank of England could not create non-cash money, and why commercial banks could not be prevented from doing so. If this were done there would be a substantial seigniorage benefit to the exchequer, and a loss of "special profits" to commercial banks. On the basis of year 2000 conditions, these

figures were estimated to be £47 bn p.a. and £21 bn p.a. respectively. Current figures would be substantially higher.

30. Several schemes have been proposed to achieve this, including 100% reserve banking. A better scheme in my view is that proposed by Prof. Joseph Huber and James Robertson in 'Creating New Money: a Monetary Reform for the Information Age', New Economics Foundation, 2000. Banks would become financial intermediaries. Everything they lent would have to have been borrowed from some other party. The emphasis would shift from making money out of money, to helping the real economy.

31. It is not reasonable to expect the committee to come to a view on monetary reform as part of the current investigation. However as proposals have not been given the attention they deserve in banking and government circles, the committee may wish to recommend that the subject is debated properly before bankers become once again 'masters of the universe', and may wish to launch a separate study on the issue.

*January 2009*

## **Memorandum from the Campaign for Community Banking Services (CCBS)**

### **EXECUTIVE SUMMARY**

Competence in the regulators' oversight of institutions' strategies, and their potential consequences, and swifter more judicious action by government would probably have lessened the scale and extent of damage to the UK banking sector. However, there are steps that the UK should be taking **now** to mitigate further damage in the future.

From the CCBS perspective of sustaining and improving access to banking, a meaningful trial of branch sharing (to avoid branch closures) is long overdue as is a reversal of the competition authorities' refusal to apply local market choice principles to retail banking as it does with supermarkets and as is done with banking elsewhere.

The expensive doubling up of RBS and NatWest branch representation in 312 England & Wales town centres needs to be addressed by UKFI, as representative of the majority shareholder, in order to realise cost savings and defer any premature closures of NatWest 'last banks' pending a sharing alternative becoming available.

The writing is on the wall and there can be no excuses for failing to seize the opportunities the crisis presents to prevent future problems of banking access.

### **EVIDENCE**

The Campaign for Community Banking Services is a coalition of national charities and similar organisations which share concerns at the loss of access to banking services in local communities and the adverse impact this has on vulnerable individuals, small businesses, sustainability of communities, financial inclusion and carbon emissions. Details at [www.communitybanking.org.uk](http://www.communitybanking.org.uk)

The evidence below is restricted to areas within the Committee's terms of reference where CCBS has something relevant to say and the expertise to back it up.

#### **Protecting the taxpayer**

2.2 It can be argued that Northern Rock, Bradford & Bingley, and other similar institutions are peripheral to the mainstream banking system on which our economy depends as they did not offer current account facilities at all, let alone to the huge numbers of individuals and small businesses that the major banks serve. It is peremptory withdrawal of the liquidity and payments systems associated with current accounts that represent the most urgent threat to the financial system and therefore demand support from government in the event of crisis.

With the benefit of hindsight it would have been much better for the problems of Northern Rock to have been dealt with by the putative Lloyds TSB take-over and/or the Deposit Protection Scheme (regrettably allowed to have become inadequate prior to the crisis), rather than for it to have become the signal for a huge loss of confidence affecting much larger and more crucial institutions.

2.3 As explained above, the main 'high street' banks are in a special category with regard to the working of the economy and once they began to be affected by the loss of confidence, which could have been avoided by earlier action on the 'peripherals' and with more effective scrutiny of the majors' own strategies by the regulators, there was little alternative to the actions taken by government although their shape and content could have been better thought through.

2.5 UKFI cannot afford to ignore its unique role as shareholder representative of the taxpayer as the electorate will not be slow to pick up on actions, or lack of them, by banks in which the public has become involuntary investor as a result of what they will perceive as mismanagement in the past.

Whilst sound(er) business management by the banks concerned is crucial to the objective of an early return to the private sector, this is not necessarily in conflict with socially and politically beneficial objectives. For example CCBS' proposals for shared community banks and banking centres in the less remunerative, but socially deserving, urban and rural communities are capable of achieving savings of up to £1bn a year in delivery costs compared with maintenance of the present bottom and middle tiers of established branch networks which would otherwise be eroded over time as a result of increased pressure on profits following the crisis. 'Bank Closure Problems-One Solution Fits All' is available at [www.communitybanking.org.uk/reports.htm](http://www.communitybanking.org.uk/reports.htm)

In specific relation to RBS/NatWest, where the government has a controlling shareholding, UKFI should encourage a serious review of the expensive duality of RBS and NatWest branch representation in 312 town centres in England & Wales, and their separate administrative and processing infrastructures, in order to realise significant cost savings and at the same time mitigate any cost driven need to close NatWest 'last banks' in rural and less affluent suburban centres in advance of a sharing alternative, as proposed by CCBS, becoming available.

## **Protecting consumers**

3.1 See our responses to 2.3 and 2.5 above. The government's responsibility to protect consumers and small businesses should not be limited to those in financial difficulty but encompass the banking needs of all vulnerable

sectors of the population which include physical access to essential banking services.

- 3.2 The provision of retail banking, especially the current account transactional capability, for individuals and small businesses has utility characteristics and is indispensable to the working of the economy. Separating it from the multifarious other, previously very remunerative, activities of the major banks would be a huge challenge and undoubtedly would have unintended consequences if not thought through in detail. Competitive choice is important but it needs to be recognised that at point of delivery the service from individual banks has already become 'commoditised' and it should not be overlooked that there is considerable scope for outsourcing (beyond the existing cheque clearing and cash transit functions) in the fields of counter and ATM provision through neutrally run community banks and banking centres whilst preserving competitive choice at various levels, including account pricing and features as is common in utilities such as gas, electricity, telephone and in other retail and service provision.

***It should be noted that the Committee's recommendation of November 2006 for the Treasury's Financial Inclusion Taskforce to investigate shared branching has, in effect, been sidelined by the Taskforce despite it formally accepting the task in April 2007.***

- 3.3 Further consolidation of the retail banking sector, particularly those providing current account services to individuals and small businesses, is potentially harmful for all the accepted anti-competitive reasons and should not even be contemplated in the absence of recategorisation of the UK retail banking market. At present, unlike in many other countries such as USA, France, Italy, the competition authorities regard the banking market as national (re-stated 21-12-07), despite applying 'local market' criteria to decisions on mergers and acquisitions in other retail sectors, such as supermarkets.

In Italy, where bank mergers are currently prevalent, there are many examples of branch disposals to competitors where mergers would result in loss of local competition. For example Banca Monte dei Paschi di Siena was required in 2008 to sell at least 125 branches to meet regulatory requirements for its acquisition of Banca Antonveneta and, earlier, 600 branches of merging Banca Intesa and SanPaolo IMI had to be sold for the same regulatory reasons and were bought by France's Credit Agricole. In the UK, on the other hand, bank mergers are not subject to such conditions and can result in individual communities being quickly reduced to one branch of one bank which is subsequently closed with little risk of business loss but considerable damage to the community's retail offering and its more vulnerable residents.

Fortunately, the current merger of Lloyd TSB and HBOS does not pose serious problems of this nature in England & Wales where the much smaller Halifax branch network is confined to larger town centres where it not only duplicates a Lloyds TSB presence but is part of a much wider choice of other banks. A very different situation would arise if a merger of any of the traditional Big 4 became necessary.

**The time to change the rules is now, not after the event has occurred.** We need to learn from experience before it is too late.

*January 2009*

## Memorandum from Landsbanki Guernsey Depositor's Action Group

### 1. Summary

1.1 The Channel Islands and the Isle of Man are Dependencies of the British Crown within the British Islands. They enjoy self-government in home affairs matters, and are therefore considered as 'non-UK' in any question of financial regulation. However, Her Majesty's Government retains paramount responsibility for the Islands: the Crown has the responsibility of protection of the Islands from all external threats (including the defence of the Islands and diplomatic representation) and is ultimately responsible for good government in the Islands. [Source: *The Scope of Guernsey's Autonomy in Law and Practice*, Richard Young. Jersey Law Review. 06/2001.]

1.2 The Landsbanki Guernsey Depositors' Action Group (LGDAG) does not feel there is adequate protection for British citizens, whether resident in the UK, Channel Islands or overseas, who deposit savings in financial institutions in the Channel Islands and the Isle of Man.

1.3 The Action Group believes there is a need for greater transparency regarding the position of British non-mainland financial centres. Many people invested in Landsbanki Guernsey in good faith without realising their savings were not protected in the event of the bank's collapse, and, having been encouraged to do so by the Guernsey authorities, relied upon the much-publicised parental Guarantee.

1.4 LGDAG strongly refutes the recent assertions by HM Government that:

- Non-resident British Citizens can open a bank account on the UK mainland

and also rebuts the allegation that:

- Depositors placed their savings in Guernsey to avoid taxation.

1.5 The Action Group strongly reiterates its belief that Her Majesty's Government should uphold its constitutional obligations to protect British Citizens of the Crown Dependencies in the British Islands against all and any foreign and external threats to such citizens and their legitimate property.

1.6 The protection of the interests of all British depositors who invested funds in affected institutions in the Crown Dependencies is unambiguously the responsibility of Her Majesty's Government by virtue of the long-standing Constitutional Convention. According to the Department of Constitutional Affairs, *'The United Kingdom is responsible for the Islands' international relations and for their defence'*, and *'The Isle of Man, Jersey and Guernsey make annual contributions towards the cost of common services such as defence and overseas representation.'* [Source: *A Guide to Government Business involving the Channel Islands and the Isle of Man, August 2002*. Constitutional Affairs: Sections: 15 *Relationship with the United Kingdom* and 23 *Economic Matters*. Department of

Constitutional Affairs website -

<http://www.dca.gov.uk/constitution/crown/govguide.htm#part2>.]

1.7 LGDAG submits that Her Majesty's Government should take urgent steps to ensure that British citizens legitimately depositing savings funds in banks in the Crown Dependencies are better protected, in line with the protection afforded to British citizens in all other areas within the British Isles, to ensure that the situation which occurred with Landsbanki Guernsey does not arise again. It is essential to raise awareness of all the risks associated with banking in Crown Dependencies for British depositors, whether or not resident there, and to ensure that they and the residents of those Islands are adequately protected, according to Constitutional obligation.

1.8 The LGDAG further submits that the British Government should implement an urgent review of the current guidelines of UK-based Banks and Building Societies, whereby some British savers are forced to bank offshore by the financial institutions, and take immediate steps to remove such inequitable impediments. Banks in The Channel Islands and the Isle of Man perform the same rigorous and extensive 'Know Your Client' checks in compliance with the Anti-Money Laundering legislation and have no apparent difficulty verifying and establishing the identity of residents outside the UK, very effectively, even if such investigations take slightly longer than the UK credit and electoral roll checks used by onshore banks.

## 2. Introduction

2.1 The Landsbanki Guernsey Depositors Action Group is the representative group for the people who saved in Landsbanki Guernsey.

2.2 The LGDAG was established following the collapse of Landsbanki Guernsey, the Guernsey subsidiary of Icelandic bank Landsbanki Islands hf on 6 October 2008. The sole and specific aim of the Group is to ensure that the savings of all depositors in Landsbanki Guernsey are returned in full.

2.3 To date, the Administrators for Landsbanki Guernsey have agreed to pay the 2,033 depositors in the bank just 30p for every pound they saved. **Depositors therefore stand to lose 70% of their savings together with the interest accrued prior to the bank's collapse.**

2.4 Many depositors are suffering real financial hardship due to the inaccessibility of their funds since 7<sup>th</sup> October. The overwhelming majority of depositors are of advanced years and rely on their savings to supplement pension income.

2.5 The UK's Financial Services Compensation Scheme (FCFS), Iceland's protection scheme, and Guernsey's Deposit Protection scheme do not cover depositors in Landsbanki, Guernsey. This was established in Guernsey on 26<sup>th</sup> November 2008, but will not be retrospective and will therefore not cover the losses of savers in Landsbanki.

2.6 Depositors in Landsbanki Guernsey are ordinary, responsible, hard working people who face significant hardship and distress following the loss of their life-savings. The overwhelming majority are British Citizens.

2.7 The LGDAG estimates that at least 94% of depositors in Landsbanki Guernsey are British Citizens. This figure is comprised of 6% Jersey, 39% Guernsey and Alderney residents [Source: Deloitte & Touche plc, Administrator's Statement dated 16<sup>th</sup> October 2008.] with the balance comprised of almost exclusively other British citizens, the vast majority of whom are resident abroad.

2.8 Those British savers who are non-UK resident were compelled to open accounts in the Crown Dependencies, as almost all UK-based banks will not allow a British Expatriate to open a bank account.

2.9 Ian Pearson, MP, Economic Secretary, HM Treasury, has asserted that this is not the case. [Source: *Icelandic Banking Debate*, Cols. 469 and 470, Commons Publications, Hansard. 06-Nov-08.]

2.10 As a result of this statement, and others by the Chancellor and other members of HM Government - and prompted by the publicity they received - an extensive survey of 58 bank and building society accounts, together with other related issues, was undertaken in November 2008.

2.11 The research showed that only two small building societies in the UK were prepared to open accounts for British expatriates and then only on personal application at the branch. Without exception, the reason given for refusal was **the Anti-Money Laundering 'Know Your Customer' guidelines which, although Expatriates are not barred by law from opening or maintaining an existing UK account, have effectively prohibited them from doing so in practice.**

2.12 In addition, a number of savers in Landsbanki Guernsey originally opened their accounts with the Cheshire Building Society in Guernsey, which subsequently was bought by Landsbanki in 2006. They were given no opportunity to change banks until their fixed term deposits matured.

2.13 The LGDAG submits that there are a number of options open to the Government to assist and, in pursuance of their Constitutional obligation, to protect distressed British Citizens against threats to person or property.

2.14 These options, which would impose no burden on UK mainland taxpayers, would facilitate the return of depositors' savings and put an end to the immense ongoing distress of those who have lost their hard-earned money, especially pensioners.

2.15 The Group submits that Her Majesty's Government should consider the following measures:

- Prior to its collapse, £38.8 million was transferred from Landsbanki Guernsey to its UK-based sister bank Heritable.

We suggest Her Majesty's Government should be able to take steps to ensure that this sum is returned to the Guernsey branch at an early stage to help reimburse depositors.

- We also suggest that Her Majesty's Government should work closely with the States of Guernsey and the Icelandic authorities to ensure that personal depositors are fully recompensed, in the same way that Her Majesty's Government assisted British savers in Bradford & Bingley in the Isle of Man, and Northern Rock in Guernsey.
- We believe that urgent and constructive discussions should be held between Her Majesty's Government and the Icelandic Government, together with the States of Guernsey, Jersey and Alderney. This is essential, if the interests of all British Citizens who deposited savings in Landsbanki Guernsey are to be protected and defended with the same vigour as that afforded to the interests of British savers in Icelandic banks within the United Kingdom.
- Depositors who opened accounts with Landsbanki Guernsey largely did so based on the Parental Guarantee issued by the former National Bank of Iceland - Landsbanki Islands hf. This guarantee was strongly promoted by the Guernsey Financial Regulator and the Bank as an effective protection for savers.

The Action Group therefore petitions Her Majesty's Government to bring all possible pressure to bear on the Icelandic government to ensure that this formal guarantee, which we were given to understand by the authorities was legally binding, is honoured. The Icelandic Ambassador has stated in the press, and reiterated privately to the Action Group, that Iceland intends always to honour its obligations. We look to Her Majesty's Government, under the constitutional obligations of external protection, to aid its citizens to ensure expedient compliance in this regard.

- The LGDAG also submits that conditions on any and all loans extended by the UK to the Icelandic Government, to support retail savers who have lost their savings because of the collapse of Icesave, must be extended to cover all British citizens, including those who are retail depositors in Landsbanki Guernsey.
- The LGDAG submits that the frozen Landsbanki assets held by the UK Government since 8<sup>th</sup> October should be used to safeguard the position of distressed depositors in Landsbanki Guernsey particularly as these depositors have a valid legal claim under the Parental Guarantee against the assets of Landsbanki Islands hf.

2.16 The Action Group has for several weeks been requesting a meeting with HM Treasury. Yet, whilst the Treasury readily agreed to meet with representatives of

savers from Kaupthing, Singer & Friedlander, Isle of Man, the Treasury has only now agreed to meet with representative of Landsbanki Guernsey at a date in 2009, yet to be determined.

### **3. Protection of British Nationals Investing Funds in The Crown Dependencies in the British Islands**

3.1 LGDAG does not feel there are currently adequate safeguards for British citizens who place funds in the Crown Dependencies, whether resident there, on the mainland, or overseas. Furthermore, there is significant confusion among consumers about what, if any, protection covers their savings.

3.2 The Banks and regulatory authorities in the Islands promoting Parental Guarantees as a method of protection have exacerbated this confusion. Such purported protection has now been thoroughly discredited by the collapse of Landsbanki.

3.3 Depositors in Landsbanki Guernsey are not protected by the Financial Services Compensation Scheme (FSCS). The FSCS only covers deposits in financial services in the UK and, in some cases, European firms which operate in the UK. Furthermore, Guernsey is not part of the European Economic Area and as such is not obliged to have a state compensation scheme under the EEA Agreement.

3.4 On 26<sup>th</sup> November 2008, the States of Guernsey announced that it had established a Depositor Compensation Scheme to compensate retail depositors up to £50,000 each, if a locally-based bank fails. Unlike the Isle of Man's scheme, Guernsey's will not be retroactive and therefore will not protect those people who lost money following the collapse of Landsbanki Guernsey.

3.5 The total claim on the scheme is capped at £100 million. This means that the fund, even if fully subscribed, will contain only sufficient funds to reimburse up to 2,000 depositors with £50K or more, in the event that another such catastrophe should arise where the Island-based bank is left without significant liquid assets due to upstreaming of funds to sister or parent banks elsewhere. This is less than the number of savers in Landsbanki, Guernsey and considerably less than many other banks on the Island.

3.6 The Action Group is at one with Her Majesty's Government in one specific area. Both parties agree that there is a need for greater transparency regarding the position of financial products in the Crown Dependencies.

3.7 Many people deposited their savings in Landsbanki Guernsey without realising their money was not protected in the event of the bank's collapse.

**3.8 Those who had inquired into the level of protection they had were led to believe by the bank, the Guernsey regulator and the Icelandic authorities, that their savings were safe and protected in full.**

3.10 It was frequently reiterated by the various Government bodies and others that, *'Landsbanki has given an undertaking to discharge those liabilities of LG which LG is unable to discharge from its own assets, whilst it remains a Landsbanki subsidiary'*.

3.11 Following the collapse of Landsbanki, there have been vague assurances given that Her Majesty's Government has *'made representations'* to the Icelandic government on behalf of British savers in Landsbanki Guernsey; however there has been no tangible evidence to support these assertions. As a result, regrettably we have been compelled to seek further clarification under the Freedom of Information Act.

3.12 The Action Group reiterates the established historical processes and accepted practice, [Source: *A Guide to Government Business involving the Channel Islands and the Isle of Man*, August 2002. Constitutional Affairs, section 3. Department for Constitutional Affairs website] that Her Majesty's Government has a binding and long-standing Constitutional obligation to protect British Citizens and residents of the Crown Dependencies against foreign threats. *'The United Kingdom is responsible for the Islands' international relations and for their defence.'* [Ibid. Relationship with the United Kingdom, Section 15.]

3.13 In addition, Protocol 3 to the Act of Accession to the European Community describes the Crown Dependencies as *'territories for which the Government of a Member State is responsible in international matters'*.

3.14 LGDAG submits that Her Majesty's Government did not take into consideration its Constitutional Responsibilities to the Crown Dependencies when it blocked the US \$2.1 Billion IMF loan to Iceland, which only ensured that mainland depositors were protected. The Group believes that this was an ideal opportunity to extend this protection to all British savers including those in the Crown Dependencies, which was missed.

3.15 The Group formally calls upon Her Majesty's Government to make every effort to protect the interests of **all** British Citizens, including those banking in the Crown Dependencies, in these circumstances.

#### **4. The Impact of the Banking Crisis on Consumer Confidence in Financial Institutions**

4.1 The collapse and fate of Landsbanki Guernsey has had a significant impact on confidence in the financial system on the Islands. The impact of capital flight from all the Crown Dependencies will be significant and devastating to their economies. It is vital to the UK's national interest that this situation is prevented from reoccurring.

4.2 The implementation of a Depositor's Compensation Scheme, implemented on 26<sup>th</sup> November by the States of Guernsey, was recommended in the Edwards Report 'Review of Financial Regulation in the Crown dependencies', in 1998. This

was not acted upon until after the failure of Landsbanki Guernsey some ten years later – a significant regulatory failure in Guernsey.

## **5. The Ability of British Expatriates to Open UK Bank Accounts**

5.1 The LGDAG strongly repudiates Ian Pearson MP's statement, in which he claimed that:

*"On the question whether [sic] depositors in the Isle of Man or Guernsey had any choice in the matter of opening offshore accounts, or whether non-UK residents are forced to open accounts offshore, I can confirm that this is not the case."*

*"There is no legal bar under UK financial services regulation that would prevent a non-UK resident from opening a new bank account here. When an account is opened remotely, more onerous anti-money laundering checks are, quite properly, required because of the increased risks involved. This might well be a factor in the willingness of some UK banks to offer new accounts to non-residents. However, this would not be a burden for customers who move offshore but wish to retain existing accounts."* [Source: *House of Commons Icelandic Banking Collapse Debate, Hansard* – Thursday 06-Nov-08.]

5.2 Mr Pearson's comments are misleading and disingenuous. While indeed the actual Law may not prohibit expatriates from maintaining or opening bank accounts in the UK, *'according to the guidelines of the Joint Steering Committee Money Laundering, the onus is firmly on financial institutions to 'Know their Customer'*.

5.3 As a result, *'Although there is a slight variation between banks' and building societies' approach to enforcing and implementing the guidelines, the end result has been to prevent expatriates from opening bank accounts onshore.'* The survey of 58 financial institutions, referenced earlier, overwhelmingly confirmed that it is effectively impossible for British expatriates to open mainland accounts legally. Indeed, there is evidence to show that some banks use the *'Know Your Customer'* guidelines as a means of pressuring existing customers moving overseas to transfer their accounts to their branches in one of the Crown Dependencies or close them.

5.4 Following Mr Pearson's misleading statement, senior bank officials with the UK High Street banks have confirmed in writing that, *'non-resident British Citizens are not eligible to open UK bank accounts'*.

5.5 These findings are borne out elsewhere. *'All the high street banks contacted by The Herald this week were puzzled by the minister's statement . . . The banks all said that this [the need for a UK address] was due to the government's money laundering regulations. The Treasury failed to return calls yesterday, seeking explanation of the minister's comments.'* [Source: *Banks puzzled by minister's comment. Simon Bain, Glasgow Herald. 22-Nov-08.*]

5.6 The LGDAG submits that as British citizens resident outside the UK are not prohibited by law from opening or maintaining a bank or building society account, the present situation is grossly inequitable and has come about as a direct result of the narrow interpretation of 'Know Your Customer' guidelines implemented by those institutions.

5.7 The implementation of this policy has directly contributed to the situation in which many depositors in Landsbanki, Guernsey now find themselves with the loss of all their savings. Had they not been forced to keep their savings offshore, and been able to open UK accounts, they would have been afforded the same protection provided to all other UK citizens.

## **6. The Payment of Taxes on Interest Arising in the Crown Dependencies.**

6.1 The LGDAG strongly denies the Chancellor's assertion that many savers deposited money in Crown Dependencies to avoid paying taxes.

6.2 The Chancellor's statement '*...the recent financial turbulence has highlighted potential problems with overseas territories and crown dependencies, such as the Isle of Man and Channel Islands. They attract banking customers with lower taxes – without contributing to the UK Exchequer.*' [Source: Pre-Budget Report, Commons Publications, Hansard, Col. 490. 24-Nov-08.] is patently untrue in the case of small depositors resident in the British Islands who were using their own high street banks and paying their Island taxes, and expatriates – who, as has been comprehensively demonstrated, had no choice but to place their sterling savings and pensions offshore.

6.3 British and other EU residents pay their taxes. '*Although not members of the EU, both Guernsey and the Isle of Man are signatories to the European Union Savings Directive 2005 (EUSD), which forces EU resident savers depositing money in any country other than the one in which they are resident to choose between forfeiting tax on interest earned, at the point of payment, or allowing notification by the offshore banks to tax authorities in their country of residence. This tax affects any cross-border interest payment to an individual resident in the EU.*' [Source: *European Union Savings Directive FAQs* on HMRC website]. Depositors living outside the EU are usually taxed on their global income in their country of residence.

## **7. Conclusion**

7.1 The LGDAG is committed to ensuring that its members' hard earned money, saved in good faith in Landsbanki Guernsey, is returned in full. The LGDAG believe this can be achieved without additional cost to the UK taxpayer.

7.2 The Group submits that Her Majesty's Government is obliged to protect all its citizens against external threats and therefore it should take urgent steps to that end, to ensure greater transparency and to raise awareness of the risks that consumers face when they save in the Crown Dependencies.

7.3 The Group also believes that as a matter of urgency, the Government should take all possible action on their behalf to vigorously support these distressed British savers. Many of them are pensioners who relied on the interest generated to boost their pensions and all of whom appear to have lost a major part of their life-savings through no fault of their own.

7.4 The Landsbanki Guernsey Depositors Action Group will be happy to provide further information, including providing oral evidence, if the Committee feels this would be beneficial.

*January 2009*

## Memorandum from Incisive Media

**Incisive Media**, are a major financial publisher, specifically addressing clause 1.11 of the terms of reference for the inquiry.

“1.11 The role of the media in financial stability and whether financial journalists should operate under any form of reporting restrictions during banking crises.”

### Summary

A rejection of the proposal implicit in clause 1.11 that the media should be subject to reporting restrictions. Such controls are wholly inappropriate in the modern age, impossible to implement effectively and their imposition would exacerbate any crisis.

### Submission

1. Many journalists with a long experience in the specialist financial press feared right from the start of the current financial crisis that we would face calls for the press to be regulated and gagged. Those fears were realised with the publication of the Treasury Select Committee’s terms of reference. Unfortunately, we live in an age where the accuracy and truth of what we publish seems to matter less than how we discover the truth and who it inconveniences. I would appeal to the Treasury Select Committee not to take us even further down that road.

2. It is hard to understand the lack of comprehension of communication and public expectations in the 21st century that this threat to gag the media represents.

3. One of the principal reasons for the extension of the inquiry to cover this is the suggestion that the BBC’s Robert Peston somehow caused or contributed to the crisis through his excellent reporting, initially, about the problems facing Bradford & Bingley, and subsequently about the wider behind-the-scenes discussions between the banks and the Treasury in the run-up to the HBOS/TSB merger. It is, in essence, about blaming the messenger. Regulators and the financial institutions they are meant to regulate will be very supportive of any proposal to regulate the press and the committee must treat this support with the greatest suspicion. Regulators and financial institutions have a vested interest in covering up their collective and individual incompetence which is the real reason why western economies are facing the worst crisis since the Great Crash of 1929.

4. You then have to consider who would be exposed to such regulation and control. It would, inevitably, be mainstream broadcasters and publishers that, on the whole, tend to act responsibly and have a well developed sense of public duty, a duty that cuts both ways: when to publish and when not to publish. Beyond the reach of any regulator will be the sprawling, global network of bloggers and their message boards and forums where all manner of

irresponsible rumours and misinformation can gain wide coverage very quickly. Who would they rather become the trusted source of information on a crisis Robert Peston or whizzyboy36 writing on a blog hosted on a web server in Uzbekistan?

5. The next key issue is perhaps even more fundamental: What right do regulators and financial institutions have to withhold information about people's savings, mortgages, pensions and so on? Throughout this crisis there has been an almost callous lack of awareness among senior figures in the financial world of the damage they have done to ordinary people, people who trusted them with their financial well being. More than ever, ordinary people will not countenance any move that appears to deny them information about what is happening to their money. For them the BBC has been a far more reliable source than any government minister, regulator or institution.

6. Incisive Media, already has first hand experience of how regulators will use any new powers they are given to gag the media and prevent it from publishing information that should clearly be in the public domain and it is an example that serves as a stark warning to anyone who believes financial regulators should have any say over the media.

7. During last summer one of our specialist weekly magazines, Professional Pensions, published a story about The Pensions Regulator and the action it was about to take against a firm of pensions trustees. The story was checked and double-checked and was 100% accurate – the facts have never been disputed. It was a model of responsible journalism. The reaction of The Pensions Regulator was to threaten our reporter with prison, demand to know our sources and require every document we had in relation to the story. It believed that it had the absolute right to control information about such matters and that it had the powers in the Pensions Act 2004 to enforce that right. Indeed, the Act does give it extensive powers and contains no reference at all to the public interest.

8. Who benefits from allowing this regulator to wield such power? Not the market. Rumours had been flying around that the regulator was concerned about a firm of trustees and that the regulator was going to take some drastic enforcement action against them but no-one knew which firm was in its sights. Consequently, the whole market had a dark shadow cast across it with reputable firms being asked if they were in trouble. Our story cleared that up by naming the firm concerned. Not people in pension schemes over which this firm wielded influence. In the 21st century it is just absurd to think that people do not have a right to know that a firm that has been appointed in guardianship over their pensions has fallen considerably short of what is expected of them, as it turned out to the extent of now being investigated by the Serious Fraud Office. It would have been the case, as it nearly always is, that the only people who benefit from greater secrecy are the incompetent and the criminal. We resisted every demand made by the regulator and are now actively promoting an amendment to the legislation to ensure that the public interest has to be considered before it can invoke the draconian powers it has been given. The Treasury Select Committee

would be very unwise to listen to proposals to empower a wider range of regulators in such a way.

9. The final huge flaw running through the proposal is the notion of a “banking crisis”. The suggestion from the terms of reference for the inquiry is that the controls on financial journalists, whatever form they may take, would only be imposed at a time of crisis. How do you define a banking crisis? Who says that the triggers set out in any definition have been pulled? You would end up with a quite bizarre situation that would actually make the problem worse. The proposal, one is to assume, aimed at stopping panic by preventing journalists reporting that banks are in trouble. However, in order to prevent them reporting that banks are in trouble, a regulator or the government would have to declare the banking system to be in crisis. Now that is really going to reassure people.

10. It is such an ill-thought out suggestion that the Treasury Select Committee would be well advised to drop it very quickly.

### **About Incisive Media**

Incisive Media is a leading global provider of specialised business news and information, in print, in person and online. The company's principal markets include financial services, legal services, marketing services and risk management. Incisive Media's market-leading brands include *Accountancy Age*, *Computing*, *Investment Week*, *Legal Week*, *Post Magazine*, *Risk*, *Central Banking Journal*, *Search Engine Strategies* and *The American Lawyer*. For more information, visit [www.incisivemedia.com](http://www.incisivemedia.com).

It has around 2,000 staff in 27 offices across three continents.

### **All Party Parliamentary Group on Insurance & Financial Services**

The All Party Parliamentary Group on Insurance and Financial Services was founded in 1991 following an initiative by *Post Magazine* to improve communication between the insurance industry and Parliament. It has since widened its brief to embrace broader retail financial services and pensions issues.

*Post Magazine* still provides the secretariat for the group and maintains a website to promote it. Over 60 Parliamentarians are currently members of the group. A full list of members and more information on the group's activities can be found on its website [www.appgifs.org.uk](http://www.appgifs.org.uk).

*January 2009*

### **Memorandum from the International Securities Lending Association (ISLA)**

1. The International Securities Lending Association (ISLA) would like to submit the following evidence to the Committee in response to its call for evidence on the banking crisis. Our submission relates only to item 1.14 *The impact of short-selling in the banking crisis and its regulation*.

### Executive Summary

- In general, share prices are driven by changes in the underlying fundamentals of companies and not by the actions of particular groups of buyers and sellers.
- Short selling did not cause the falls in bank share prices since 2007.
- UK financial share prices have continued to fall and remained volatile following the imposition of restrictions on short selling by the Financial Services Authority in September. Independent academic research has found that the restrictions in the United Kingdom and elsewhere have had no discernible effect on subsequent movements in the prices of financial shares.
- But, based on research by the London Stock Exchange, those restrictions have reduced liquidity in the market for financial shares and raised trading costs for investors.
- They have also constrained the ability of investors to hedge their positions and led to significant compliance costs for market participants.
- ISLA welcomes the planned consultation by the Financial Services Authority on regulations for short selling. Any new regulations should be linked to clear regulatory objectives, follow full and open consultation, be evidence-based, have a sound legal basis and be subject to rigorous cost-benefit analysis, as required under the Financial Services and Markets Act 2000.
- ISLA also welcomes the initiatives by IOSCO and CESR to harmonise regulation of short selling internationally, as differing rules create confusion and compliance costs for market participants.

### The role of short selling in the banking crisis

2. In our opinion, short selling did not cause the falls in UK bank share prices since 2007. As has now become clear, those falls reflected fundamental problems with the business models and risk exposures of banks.

3. In September, ahead of the restrictions on short selling imposed by the Financial Services Authority, it was suggested that short selling had exaggerated the falls in UK bank share prices. At that time, we said that our members had seen no evidence of significant short selling of UK bank shares. The best available (albeit imperfect) indicator of short selling pressure is the change in the value of borrowed shares, which can be monitored using data collected by Euroclear UK and Ireland<sup>7</sup>. Share borrowing is an indicator of short selling as a (covered) short seller must borrow the shares in order to deliver them into the

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<sup>7</sup> Please note, however, that shares are also borrowed for other reasons: for example, to prevent chains of failed settlements.

short sale. To take the example of HBOS, which was widely discussed at the time, borrowing of its shares was broadly stable in early September (see Chart 1). Significant short selling would have been reflected in a sharp pickup in securities borrowing. In our opinion, the fall in HBOS share price reflected fundamental concerns about its business prospects rather than pressure from short selling. Indeed, subsequent data has shown that the selling at that time was largely by long-only institutional investors.



### Short selling and share prices

4. Academic research has shown that restrictions on short selling reduce market efficiency and liquidity<sup>8</sup>. Studies have found that allowing short selling:

- means prices adjust more quickly to new information about fundamentals;
- decreases the likelihood of price bubbles;
- leaves unchanged or even reduces the probability of price crashes;
- may lead to higher equilibrium prices: because investors have greater confidence that prices are fair and therefore require lower returns to compensate them for risk.

5. In its 2002 Discussion Paper, the UK Financial Services Authority concluded that short selling is a 'legitimate investment activity which plays an important role in supporting efficient markets. It accelerates price corrections in overvalued securities, it supports derivatives trading and hedging activities and

<sup>8</sup> For a summary of the academic literature, please see <http://www.isla.co.uk/docs/Securities%20Lending%20and%20Short%20Selling.pdf>.

facilitates liquidity and trading opportunities. We therefore see no case for any prohibition on short selling, either generally or for particular stocks in times of market stress.'

6. Only a proportion of short sales reflect a simple directional view that a share price will fall. More commonly short sales are to hedge long positions in the underlying shares or associated derivatives: for example, selling the components of an index short against a long position in the index future; or selling shares short in order to delta hedge an options position.

#### The effectiveness of the short selling restrictions introduced in September

7. Together with the London Investment Banking Association and the Alternative Investment Management Association, ISLA commissioned independent academic research by Professor Ian Marsh of Cass Business School to examine whether the short selling restrictions introduced in various countries in September had had any effect on share price returns. The research paper can be found at <http://www.cass.city.ac.uk/media/stories/resources/the-impact-of-short-sales-restrictions.pdf>.

8. The main findings were:

- No strong evidence that restrictions on short selling changed the behaviour of stock returns. Stocks subject to the restrictions behaved very similarly both to how they behaved before their imposition and to how stocks not subject to the restrictions behaved.
- Comparing behaviour across countries where the nature of the restrictions differed, no systematic patterns consistent with the expected effect of the new regulations, i.e. no evidence of a reduced probability of large price falls.
- No sign of any detrimental impact of the constraints in terms of reduced efficiency of pricing.
- Regression analysis suggested that changes in stock returns were driven mainly by other factors affecting the financial sector as a whole rather than the restrictions on short selling. That is, some systematic changes in the behaviour of financial sector stocks could be discerned, but no strong evidence of a systematic impact of the restrictions could be identified.

9. In summary, the authors found no evidence that the restrictions had had any impact on share price returns.

#### Costs of the restrictions

10. The restrictions on short selling imposed by the Financial Services Authority in September were introduced without consultation or notice. Restrictions were then introduced in many countries worldwide, also without consultation or notice. The restrictions differed between countries and were frequently unclear or not fully specified, requiring subsequent clarifications. Compliance costs for financial firms have been significant at a time when they are facing many other pressures. Regulators have also devoted significant time to these measures when they have many other urgent priorities.

11. The regulations have made it impossible to carry out some established trading strategies (eg long: short equity, convertible bond arbitrage, model-based trading), obliging investment funds to close out positions and, paradoxically, leading to some forced selling of securities.

12. Research by the London Stock Exchange has found that liquidity in the restricted UK bank and financial stocks fell and trading costs rose following the introduction of the regulations. Similar results were found in the US market following the introduction of short selling restrictions there.

13. The main findings of the London Stock Exchange report were that, comparing restricted stocks (ie bank and financials) to a control group of unrestricted stocks:

- The widening of bid:offer spreads was 150% greater;
- The decrease in depth on the order book was 37% greater;
- Trade and volume fell by approximately 10% whereas it rose for unrestricted stocks;
- Turnover fell by 21% whereas it rose for unrestricted stocks.

14. Results of two separate regression analyses showed that the observed decline in liquidity occurred independently of market-wide changes and increased volatility, respectively. The models are economically and statistically significant and suggest that banned stocks in the post-ban period had lower liquidity compared to the control sample and after controlling for market-wide variables.

### Future regulations

15. ISLA does not believe there is a case for a continued ban on short selling, either of all stocks or particular types of stocks.

16. We welcome the planned consultation by the Financial Services Authority on regulations for short selling. Any new regulations should be linked to clear

regulatory objectives, follow full and open consultation, be evidence-based, have a sound legal basis and be subject to rigorous cost: benefit analysis, as required under the Financial Services and Markets Act 2000.

17. We also welcome the initiatives by IOSCO and CESR to harmonise regulation of short selling internationally, as differing rules create confusion and compliance costs for market participants.

18. Our understanding is that possible regulatory objectives in relation to short selling include:

- *Preventing any 'abusive' trading, perhaps combined with rumour mongering, intended to create artificial price movements and leading to share price volatility that threatens fair and orderly markets.* In general, we think 'abusive' short selling should be controlled under general market abuse regulations: for example, to prevent spreading of market rumours or trading strategies designed to manipulate market prices. In this context, we understand that regulators may want to require regular reporting to them of individual short positions or transactions as a basis for their market monitoring. But we see no case for publication of individual positions or transactions.
- *Providing information to investors about aggregate short interest in securities in order to improve market efficiency.* We see the argument for publication of periodic aggregate statistics provided these are meaningful and the benefits justify the costs of collection.
- *Ensuring efficient settlement of transactions.* We support settlement discipline regimes designed to encourage timely settlement and prevent persistent fails to deliver. But these should not be unduly restrictive in ways that penalise unintended failed trades excessively and may actually distort markets. UK settlement in CREST UK and Ireland currently works well.

#### About ISLA

19. **ISLA** represents the common interests of nearly one hundred borrowers and lenders of securities in Europe, Asia and the Middle East. While based in London, it has members in more than twenty countries. More information is available at [www.isla.co.uk](http://www.isla.co.uk).

January 2009

## Memorandum from Equifax

### 1. Executive Summary

2.1 Equifax, a global leader in information solutions and one of the largest credit assessment, ID verification and fraud prevention solution providers, is delighted to respond to the Treasury Select Committee's inquiry into the banking crisis.

2.2 This submission briefly outlines some of our experiences in the U.S. supporting lending and mortgage practices between businesses which we hope will be helpful to the Committee.

2.3 In the U.S. Equifax has recently been working with credit rating agencies and businesses to enhance their ability to make informed decisions about the transactions they participate in. The products that Equifax has developed in the U.S. provide companies with a detailed portfolio of information not currently available through traditional credit scoring. This data then allows companies to make better informed, responsible decisions about whether they would like to undertake a specific deal or transaction.

2.4 In the current market, this information is proving to be a vital tool in the process of rebuilding trust amongst businesses and lenders – it increases transparency and facilitates responsible lending decisions. We believe that going forward products such as these will play a crucial role in supplementing the traditional information provided by the credit rating agencies.

2.5 We would be delighted to meet with the Committee or the inquiry manager to discuss this document and our work in greater detail.

### 2. Equifax submission

*In this submission we would like to address the following specific areas outlined in the Committee's call for evidence:*

**1.2 The role, and regulation, of credit ratings agencies in the banking crisis, and whether any reforms are desirable.**

**1.8 Possible improvements to the architecture of international financial regulation and maintenance of global financial stability.**

*The following section answers points 1.2 and 1.8 together.*

3.1 Asset-backed securities (ABS) investors are continually challenged with accurately predicting delinquency, default and prepayment, as well as valuing securities and understanding broader market trends.

3.2 The sub-prime mortgage crisis has engendered a new uncertainty for buyers of whole mortgage loans, mortgage backed securities (MBS) and ABS. In particular, investors in MBS and ABS have historically had very little information

on which to base an assessment of the credit risk posed by the underlying borrowers in a mortgage pool.

3.3 In the U.S. Equifax has developed a new tool which monitors the changing credit health of borrowers by providing investors with up-to-date consumer risk scores and well informed indicators of mortgage default for securitised mortgage and home equity loans. This data supplements traditional credit scoring with additional consumer credit behaviour including risk and bankruptcy scores which allow investors to continually analyse opportunities and risk in greater detail.

3.4 In particular, this tool provides businesses with the ability to estimate the likelihood of a consumer becoming 90+ days past due within 24 months of scoring and projects consumer bankruptcy within the 24 months from scoring.

3.5 We believe that this new resource generates greater transparency, allowing investors to make better informed, responsible decisions.

3.6 Looking ahead, tools such as these should form a core part of the investment and lending process, providing an additional reference point to traditional credit scoring. The ability to track trends and better predict ability to pay will help to restore and maintain confidence in the markets and should become a crucial part of future business practices.

### **3. About Equifax**

4.1 Equifax in the UK was established in 1989 and has around 500 employees with sites in London and Bradford. We serve customers across a wide range of industries including financial services, retail, healthcare, telecommunications/utilities, brokerage, insurance and Government departments.

4.2 Originally established in the USA in 1899, we are headquartered in Atlanta, Georgia, and employ approximately 6,900 people in 14 countries through North America, Latin America and Europe. Equifax is a member of Standard & Poor's (S&P) 500® Index.

4.3 We are the world's largest repository for consumer credit information, and in the UK we hold approximately 400 million records on 45 million individuals. Our commercial databases contain information on 2.1 million limited companies as well as information on a significant number of non-limited companies.

4.4 We receive in the region of 192 million updates to this information each month from a range of public and private sources including Government bodies such as Local Authorities (Electoral Roll), HM Court Services (via Registry Trust Ltd) and organisations involved in granting credit, including all the banks, credit card companies, mortgage providers, mobile telecommunication providers and mail order companies.

4.5 We use this data to provide services to business, individuals and Government. In particular we offer:

- consumer and business credit intelligence
- portfolio management
- ID verification and fraud prevention
- decision-making technology
- marketing tools

4.6 Our business model is based on secure, accurate data. As such, we invest heavily to ensure that our databases and business processes are in line with the principles of the Data Protection Act (DPA). In the UK we have received accreditation to the Government T Scheme, as well as BS 7791 and ISO 27001 which means our processes are defined, documented and checked every year.

*January 2009*

## Memorandum from the States of Guernsey

### 1. Executive Summary

- 1.1 The Government of Guernsey's submission to this inquiry focuses on Guernsey's response to the banking crisis, and on actions taken to protect UK citizens investing in Guernsey.
- 1.2 Guernsey is a well-regulated financial centre committed to maintaining international financial stability and transparency. Guernsey is part of the sterling zone. All Guernsey banks are subsidiaries or branches of banks from other jurisdictions - there are no domestically owned banks. Guernsey is not a large retail deposit taker, and its banks are not focussed on gathering deposits from individuals.
- 1.3 Guernsey has already taken on board lessons from the global downturn, and we affirm our belief that the most important thing is how these lessons are put into practice for all jurisdictions, including Guernsey. In Guernsey we immediately decided to establish an independent review of our banking sector in order to ensure its continued contribution to international commerce and to the global financial system. We also recently implemented a depositor compensation scheme that supports both resident and non-resident individual depositors.

### 2. Introduction: About Guernsey

#### The Government of Guernsey

- 2.1 Guernsey<sup>9</sup> has its own elected legislature called the States of Guernsey. The administration of the ten Government Departments is overseen by a Chief Minister and ten Ministers who form the Policy Council. The Departments are each led by a Minister and four other elected members of the States.

#### Guernsey's relationship with the UK

- 2.2 Guernsey is a Crown Dependency. The Sovereign in Council exercises supreme legislative and judicial powers in Guernsey and has ultimate responsibility for the good government of the Island. The Crown acts through the Privy Council on the recommendations of the Ministers of Her Majesty's Government in the United Kingdom in their capacity as Privy Counsellors. The Ministry of Justice acts as the point of contact between the States and the Crown but is not otherwise involved in the Island's internal affairs. The parliament of the United Kingdom does not legislate on behalf of Guernsey without first obtaining the consent of the insular authorities. The extension of an Act of Parliament to Guernsey is exceptional. Where uniform legislation is required the ordinary practice is for the States of

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<sup>9</sup> The Bailiwick of Guernsey includes the separate jurisdictions of Alderney and Sark. Sark is a separate jurisdiction for taxation purposes whereas Alderney residents are subject to the Guernsey taxation system. There is no companies' law in Sark. All three jurisdictions are subject to identical regulation of financial services. For ease of reference the term "Guernsey" will be used.

Guernsey to enact its own “mirror” legislation. Guernsey is not, and has never been, represented in the United Kingdom parliament. The States of Guernsey is, and always has been, legislatively independent from the UK with the full capacity to legislate for the Island’s insular affairs. Guernsey’s right to raise its own taxes is a long recognised constitutional principle. The government of the United Kingdom does not provide any financial support to Guernsey.

#### Guernsey’s relationship with the European Union

- 2.3 Under Protocol 3 to the Treaty of Accession Guernsey has a special relationship with the European Union and the majority of EU Directives do not automatically apply in the Bailiwick. As far as financial services are concerned Guernsey is a third country under EU Law. Nonetheless Guernsey implements laws and regulations equivalent to those in the EU when it considers it appropriate - given the size of the jurisdiction and the nature of its economy - to do so.

#### Well-regulated international financial centre

- 2.4 Guernsey is a well regulated, transparent and co-operative jurisdiction committed to maintaining and promoting international financial stability and to combating and preventing financial crime. Guernsey has invited the IMF to re-assess the Island’s financial, regulatory and criminal justice structure and that assessment is scheduled for 2009. The assessment will also include financial stability elements in the banking and insurance sectors. We look forward to the results of the IMF’s assessment and believe that it will confirm our continuing success in meeting international regulatory standards in these areas. Our contribution in these areas has already been substantiated by a number of international reviews, objective measures, reports and assessments over the last 10 years. In addition to the IMF’s assessments, this includes those of the UK Government through the Edwards Report; the Financial Action Task Force; the Financial Stability Forum; the International Monetary Fund (IMF); and the Organisation for Economic Co-operation and Development (OECD).

### **3. Guernsey’s Banking Sector**

#### Guernsey’s banking sector

- 3.1 Banking is central to Guernsey’s success as an international finance centre, and it is a major source of employment in Guernsey. The vast majority of deposits in Guernsey banks are corporate, inter-bank, wholesale or fiduciary deposits. Guernsey is not a large retail deposit taker and its businesses are not focussed on gathering deposits from individuals.
- 3.2 There are no domestically owned banks in Guernsey - all Guernsey banks are subsidiaries or branches of banks from other jurisdictions. Indeed the vast majority of current account and clearing bank transactions for the Island are provided by the UK’s clearing banks. Recent events have demonstrated that financial instability is imported into Guernsey rather

than exported from Guernsey to other jurisdictions. In line with all other jurisdictions around the world, Guernsey banks' strengths ultimately depend on the strengths of their parent companies. Those parent companies are incorporated in a range of jurisdictions, and we recognise that the capacity of their home jurisdictions to support them is variable. Recent economic events have brought this variability into sharp focus. The primary responsibility for supporting these banks inescapably lies with their home jurisdiction. This is true not only of Guernsey, but of every jurisdiction.

#### Guernsey's retail banking sector

3.3 As outlined above, the Guernsey banking sector is predominantly wholesale and not retail. For example the bulk of deposits in Guernsey banks are deposits with the international and private banks, accounting for some 88 per cent of total deposits, while clearing banks and deposit takers together account for 12 per cent of total deposits.

3.4 Within the retail banking sector, deposits from households and individual trusts in Guernsey remain the most important. In total, deposits from UK, Guernsey, Jersey and Isle of Man households and individual trusts represent 7.7 per cent of total deposits. Deposits from households and individual trusts in Guernsey account for 3.4 per cent of total deposits. These deposits from Guernsey households and individual trusts are proportionately more important in the deposit base of the deposit takers (representing 15.3 per cent) and of the deposit base of the clearing banks (representing 12.5 per cent). Deposits from households and individual trusts in Guernsey held with the international and private banks form only a small part of their deposit base (representing 2.1 per cent ), reflecting the international focus of their business.

3.5 As at 31<sup>st</sup> October 2008 the segmental analysis was as follows:

Type of bank	No. of banks	Deposits in £ millions	Percentage of total	Guernsey households and individual trusts in £ millions	Guernsey households and individual trusts as a percentage of segment deposits
Clearing banks	8	13,28	9.4%	1,66	12.5%
Deposit takers	7	4,11	2.9%	63	15.3%
International and private banks	34	123,71	87.7%	2,54	2.1%
Totals	49	141,10	100.0%	4,83	3.4%

### Guernsey's review of its banking sector

- 3.6 Following the global financial turmoil that accelerated during the summer of 2008, international banking has suffered a number of significant shocks. As a result global banking is likely to undergo a period of change and consolidation. The Government of Guernsey considered that this was an opportune time to instigate a review of Guernsey's banking sector. The review will look at the nature of banking business to examine the economic value to the community of each different business model, as well as how best to ensure the banking sector's continued contribution to international commerce and to the global financial system. These are essential considerations for ensuring the prosperity and stability of the sector in the Island's economy.

### Guernsey and Landsbanki

- 3.7 One of the matters that is of clear relevance to this inquiry is the collapse of Landsbanki Guernsey Limited (LGL) which was placed in administration in October 2008. LGL has a number of assets, including a deposit with its Icelandic parent Landsbanki Islands hf, a deposit with Heritable Bank in the UK (a sister company of LGL), a loan book secured on UK property and a letter of comfort from the parent company. In addition, the parent company made public statements guaranteeing deposits with LGL. Heritable is regulated by the Financial Services Authority. The Joint Administrators of LGL and the authorities in Guernsey are working to recover the deposits from Landsbanki hf and Heritable. Furthermore, as a consequence of HM Government's constitutional responsibility for Guernsey's international relations, HM Treasury is representing Guernsey in discussions with the Icelandic Government. A greater focus on regulatory considerations in this area is included in the separate submission to this inquiry from the Guernsey Financial Services Commission (GFSC), the independent regulatory body for the finance sector in Guernsey.

### Independent inquiry

- 3.8 Michael Foot, formerly of the Bank of England, the Financial Services Authority and the Central Bank of the Bahamas, has carried out an independent inquiry into the Guernsey Financial Services Commission's handling of issues around LGL as well as Northern Rock Guernsey. The review was commissioned by the Guernsey Financial Services Commission's Board of Commissioners in November 2008, and reported back in December 2008. The Commission measured up to good practice and met its obligations under international supervisory standards – there was no regulatory failure in Guernsey.

## **4. Protection of UK and non-UK Depositors**

### Response to the "credit crunch"

- 4.1 Since the second half of 2007, the credit crunch and the cases of Northern Rock Guernsey and LGL have exposed the possibility of potential losses to depositors with banks in Guernsey. This potential risk is linked to the

placement of deposits with their parent banks if difficulties are experienced by their overseas parent companies. Many Guernsey subsidiaries and branches have traditionally lent a high proportion of their balance sheet to their overseas parent. The vulnerabilities of this practice were evident to the Guernsey Financial Services Commission at the time of the Northern Rock crisis. Regulatory actions have had regard to this vulnerability.

#### Introduction of measures to protect depositors

- 4.2 Guernsey has introduced a depositor compensation scheme that protects both resident and non-resident depositors. After a consultation exercise, the States of Guernsey approved plans for the scheme on 26<sup>th</sup> November 2008 and the scheme is now up-and-running. Should the need arise this scheme provides cover of up to £50,000 for individual retail depositors, and provides access to funds within three months of a claim being made. Further measures to protect depositors may be introduced as a result of the review of the banking sector mentioned in section 3.4 above. In Guernsey the regulatory regime evolves to meet changing international standards, as well as to ensure any potential improvements that might be identified through independent reviews (such as the forthcoming IMF assessment) are made expeditiously.

*January 2009*

## **Memorandum from the Association of Independent Financial Advisers (AIFA)**

### **Executive Summary**

1. AIFA is pleased to have this opportunity to contribute to the Treasury Committee inquiry on the banking crisis. We are submitting the following documents to support our written evidence:

- Consumer Trust in Financial Services
- A Manifesto For Advice
- Financial Advice: Worth the Money?

2. Our evidence covers financial stability issues and the protection of consumers, focusing predominantly on the role of IFAs and restoring consumer trust in financial services institutions. In summary:

- Given the widespread consumer confusion and the turbulent market conditions, there has never been a more important time to relay to consumers the benefits of seeking whole of market, independent financial advice, from someone who is on their side.
- We believe it is the product provider's responsibility to ensure there is clarity in their literature regarding the product's purpose and its associated risks, method and type of investment, and to provide a clear explanation of the consumer protection for funds invested in non-UK jurisdictions. It is the IFA's role, in understanding their client's long term financial objectives, to match the individual needs of the client with a suitable investment strategy to meet these goals, including advising on any appropriate products (based on the information supplied by the product manufacturer).
- With regards to remuneration, we support FSA's proposals for Customer Agreed Remuneration (CAR). This is a move to a more transparent charging structure, which should eliminate any perceived bias and improve the reputation of the retail financial services industry.
- The FSA has recently published proposals that disproportionately increase small firm's requirement to hold regulatory capital. The IFA sector poses a minimal risk to the economy in comparison to large institutions and these proposals come at a time when firms are already facing a tough financial climate.
- We believe deposit protection needs to be set at a meaningful level but also needs to be consistent across cash deposits and other investment products. We suggest caution when considering any proposals for a pre-funded Financial Services Compensation Scheme.

### **Introduction**

3. The Association of Independent Financial Advisers (AIFA) is the representative body for the IFA profession. There are approximately 16,000 adviser firms that employ 128,000 people, and turnover is estimated at £6.5 billion (including £4.5 billion from life policies, £1 billion from fund management and £1 billion from mortgages and general insurance). Around 20% of the UK population regularly use an IFA, with c45% consulting one from time to time.

4. AIFA represent over 85% of all IFAs, who, in turn account for around 70% of all financial services transactions in the UK (measured by value). As such, IFAs represent a leading force in the maintenance of a competitive and dynamic retail financial services market.

### **Securing financial stability**

#### *Possible reforms to remuneration structures prevalent in financial services*

5. AIFA welcomes the Financial Services Authority's (FSA) recent Retail Distribution Review's (RDR) proposals for Customer Agreed Remuneration (CAR) as we believe it will help increase transparency and confidence. The removal of the product provider from the remuneration discussion should eliminate any perceived bias that exists and improve the reputation of the wider financial services industry. There are three levels of costs that must be transparent to consumers:

- The cost of initial advice (or sale)
- The cost of the product / service
- The cost of any ongoing advice

6. We must ensure all types of firms operate the same disclosure policies, as we are worried consumers may be misled that 'tied advice', from say a bank, is free or available at below the actual economic cost. It is also crucial that remuneration terminology is clear and easy for consumers to understand. We suggest that terminology should be standardised and distinctions made between:

- **'Adviser charges'** - The agreed remuneration basis that the advisory profession works on, including the upfront advice fee for analysis and recommendation; and a "recurring fee" for the cost of on-going advice.
- **'Sales charges'** - The agreed remuneration basis that firms who do not offer independent advice work on, including upfront and recurring fees.
- **'Product costs'** - The cost of the product recommended / sold by the different market participants (sometimes called the 'factory gate' price).

7. We are concerned that a 'sales driven' culture has been allowed to exist and dominate in banking groups where consumers have been led to believe they are getting 'advice' but were actually being sold a product. Clarity of remuneration policy and disclosure of status are essential to stopping a repeat of past failures and the regulator has a key role in making this happen.

*Reforms to regulatory capital and liquidity requirements and risks to financial stability emanating from non-bank financial institutions.*

8. While we understand the need to review prudential requirements, in the current economic climate we believe FSA has been rash in proposing a disproportionate increase in minimum capital requirements for advisers when they acknowledge it will “drive some firms out of the industry” (DP 08/20 Review of the prudential rules for personal investment firms). The requirements will be a heavy burden for IFA businesses and pose a serious risk to firms that are already facing difficulty in a tough financial climate. Large firms will be required to triple their capital, while a small firm of 20 advisers with £1.6million costs could be forced to increase its capital to in excess of £300,000. (It should be noted that over two-thirds of firms currently hold more than the regulator’s required minimum capital levels). For a regulator to knowingly propose changes that will put firms, currently regarded as being in good standing, out of business, appear reckless. We look forward to working with FSA to define more acceptable terms that ensure firms continue in operation while improving consumer protection.

9. There is also a strong chance that ‘Expenditure Based Requirements’ could be counter-productive and penalise good firms who have, for example, invested in extensive compliance support. The impact of the requirements could ultimately lead to some firms moving their authorisations offshore and passporting back into the UK or leaving the industry altogether. This could reduce access to independent advice to consumers at a time when it is increasingly sought out.

10. The IFA community is the sector that poses the least threat, a fact acknowledged by FSA Chairman, Lord Turner, in an interview with the Financial Times: “If you look at what we were charging the biggest banks in the world, and what we were charging some small regional IFA, the differential was nothing like as big as I think it logically should be, just given the scale of their economics and the scale of the threat to the system.”

### **Protecting consumers**

*The protection of UK citizens investing in non-UK jurisdictions.*

11. Recent events have clearly demonstrated the importance of understanding the risk involved in offshore investments. Issues have arisen over whether consumers have been made fully aware of the regulatory status of institutions in offshore jurisdictions, and whether the companies made consumers aware of how their investments were protected.

12. We believe it is the product provider’s responsibility to ensure there is clarity in their literature regarding the purpose of the product, its associated risks, method and type of investment, and supporting consumer protection.

13. IFAs are responsible for the advice they give and for ensuring they are conversant with the details of any products recommended; provided the most up to date information has been made available to them.

14. If a consumer has been advised by an IFA in the UK, the advice is covered by the Financial Services Compensation Scheme (FSCS). Therefore it is in consumers' interests to use an IFA. Any regulatory change made that would encourage IFAs to move offshore would therefore be a negative move. The respective responsibilities of each party was an issue that FSA recognised in 2007 in their paper on the respective responsibilities of providers and distributors (PS 07/11 Responsibilities of providers and distributors for the fair treatment of customers).

*The impact of deposit protection on both consumers and competition.*

15. Deposit protection needs to be set at a meaningful level but also needs to be consistent across cash deposits and other investment products in order to ensure there is no detriment to competition levels.

16. AIFA suggests caution when considering any proposals for a pre-funded FSCS. We doubt a pre-funded scheme would have been sufficient to deal with the travails experienced in 2008, and we question if it would have instilled greater confidence than the current scheme. Pre-funding of the scheme would also tie up further capital which in current market conditions would be even more costly.

17. The current Treasury loans to the FSCS, to allow time for losses to crystallise and become certain, and give the industry "time to pay" are welcome.

*The role of financial advisers in the banking crisis, and the restoration of consumer trust*

18. The professional financial advice community is a strong, diverse, profitable and structurally robust part of UK financial services. Measured by value, financial advisers generate the significant majority of all retail financial services transactions. We are also a client-focused industry; believing in the real value created by long term client relationships. We would refer the Committee to AIFA's "A Manifesto For Advice", published earlier this year to present a vision for the future of the professional financial advice community. The Manifesto gained widespread support from Members of Parliament, from consumer groups and from over 80% of IFA firms.

19. As a result of the banking crisis and consolidation of financial service institutions, it is increasingly important that consumers have access to independent financial advice. IFAs help their clients plan for their future, respond better to changing market conditions, adjust their portfolios, and if necessary purchase the product most suitable to their needs and individual financial circumstances. They need financial advisers who are acting on their behalf and in their best interests, rather than tied salespeople simply selling them products from a limited range.

20. Indeed, findings of a 'Trust Index', developed at The University of Nottingham by the Financial Services Research Forum, confirm brokers and advisers are the most trusted of all financial bodies in the UK, with banks and life insurance companies the least trusted. Comparative analysis with the results of the Index in 2005, 2006 and 2007 shows brokers and advisers are consistently the most trusted Financial Services Institutions (FSIs). The ratings for advisers who are independent are higher than for brokers who are tied.

21. Trust and trustworthiness are crucial to any exchange relationship, and nowhere is this more apparent than in financial services. The long-term nature of many financial products, their complexity, and the importance of financial assets to individual well-being, mean that customers perceive high levels of risk when making purchase decisions. Faced with such risk and uncertainty, many customers are dependent on FSIs to offer advice and products of an appropriate type and quality - and must trust them to do so.

22. However, AIFA's work on why consumers do not engage fully with FSIs has shown that they do not know who to trust, and we would like to refer the Committee to our publication 'Consumer Trust in Financial Services'. This lack of trust has only been exacerbated by the banking crisis and consumers' experience with companies such as Northern Rock and Icesave.

23. The findings of Nottingham University's Trust Index indicate that many FSIs get their highest customer ratings in relation to ability and expertise in their field i.e. 'low-level' trust. But they find it much harder to present themselves to customers in terms of 'higher level' trust, particularly in relation to shared values. In other words, while many customers might trust their insurance company to operate effectively in its sector, fewer feel that it has their interests at heart.

24. The IFA business model is based on delivering service to individuals, so is more easily recognisable as operating at the 'higher level' of trust. 98% of adults surveyed by YouGov in July 2008 on behalf of AIFA, who had dealings with IFAs in the past 3 years, state that it is their IFA who they trust most to offer financial advice. The YouGov research also showed that of the respondents who have had dealings with different FSIs in the past 3 years, 78% of those questioned trusted IFAs to treat them fairly; this is higher than the levels of trust consumers had in their dealings with banks, life insurance companies, pension providers and investment companies over the past 3 years. 80% of those questioned were also confident that an IFA considered their personal needs above all else.

25. In some sectors of the industry there is a 'myth of scarcity' (that all firms are competing to gain a greater share of a shallow pool of consumers) but we believe that public policy focus should be on attracting and re-engaging those who have turned their backs on the sector. We support the work of Money Guidance as a door-way into financial capability for those who have become disenchanted with financial services.

26. A major problem is that consumers are confused as to the role and motivations of FSI representatives as they are unsure of whether they are getting impartial advice or being sold a product. We propose that Money Guidance helps consumers understand the clear difference between 'independent advice' and 'sales', to provide clarity to consumers of who is acting as their agent, and who is acting as the agent of the product provider.

27. We trust that FSA will assist with this by introducing a new disclosure regime that makes it easier for consumers to understand what the motivation is of the person sitting across the desk from them – to offer them independent advice or sell them a product. Further, we believe this new disclosure regime should set out not only what the person can offer but also what the limits on their service are.

28. AIFA believes that the benefits to the consumer in offering absolute clarity of whether a firm is the 'agent of the client' or otherwise will go a long way to restoring trust in the sector. Unclear motivations have damaged trust, and the RDR is the opportunity to restore trust through the distinction afforded by those working for the client without potential conflict of interest. This will help to restore trust in financial services as a whole.

29. By creating more informed and confident consumers, improved financial capability will help promote a more efficient financial services market.

*January 2009*

## Memorandum from Association of British Insurers (ABI)

The Association of British Insurers (ABI) is the voice of the insurance and investment industry. Its members constitute over 90 per cent of the insurance market in the UK and 20 per cent across the EU. They control assets equivalent to a quarter of the UK's capital. Through the ABI their voice is heard in Government and in public debate on insurance, savings and investment matters.

### *General comments*

The insurance industry plays an important role in the financial services sector, not only as a provider of protection and savings products to the public, but also, through its investment activity, as a large provider of long term capital to British banks and industry. Members therefore have a strong interest in the smooth functioning of the financial system and are keen to play their part in contributing to solutions to the financial crisis.

We therefore welcome the leadership the Select Committee has shown in its enquiry into the crisis and have already been pleased to respond to previous consultations. In our evidence so far we have:

- Expressed reservations about the proposed **Special Resolution Regime** for banks, calling for greater safeguards and more effort to achieve consensus on its operation so as to minimise the loss of confidence among those investors whose rights are extinguished or varied under the regime;
- Responded on the operation of **accounting standards**, expressing our firm support in principle for the fair value approach while recognising the practical challenges that need to be addressed;
- Responded to the Committee's request for evidence on **executive remuneration**, stressing the importance of distinguishing between the remuneration of executive directors in listed companies and the overall structure of employee remuneration in investment banks.

The broad principles underlying our approach are that:

- While prudential supervision of financial institutions, needs to be more effective, we need to avoid an over-reaction, and regulatory overkill which inhibits the ability of markets to allocate capital efficiently;
- There continues to be an urgent need to restore liquidity to the money markets if business is to have access to credit. The focus needs to be on ensuring a liquid market in money market instruments;
- It is important to keep capital flowing across borders, and protectionism in new regulation should be avoided at all costs;

- Much can be achieved by greater transparency. For example, we favour disclosure above an appropriate threshold of both short and long positions taken in by investors in listed equities;
- There needs to be a determined effort among investors, companies, financial analysts and commentators to focus more on long term issues rather than short term market movements;
- Regulatory reform should seek to preserve the competitiveness of the City of London and recognise that, as we enter the recovery stage, the financial sector can and should continue to make an important contribution to the UK economy.

With these principles in mind we offer the following specific responses.

## **Specific responses**

### **Securing financial stability**

1. Q1.1 The early stages of the credit crunch were not characterised by prominent individual or systemic problems associated with **audit**. Although it is premature to conclude that publication of financial institutions' accounts for the 2008 financial year will not expose deficiencies, auditors of banks, and indeed of other large quoted companies, have been aware of the difficulties inherent in financial reporting in circumstances of market turmoil, and also of the implications of audit judgments. Our impression is that they have been bringing professional scrutiny to bear on the right basis.
2. In a system of fair value accounting, abrupt changes in market values for financial instruments and significant changes in liquidity of markets, as experienced since mid-2008, will inevitably create challenges in financial reporting. While the principle of fair value accounting is correct, we need greater understanding of how to approach the problem of marking financial instruments to market in circumstances where no market exists for them. Auditors should continue to exercise effective professional scrutiny as regards the reliability of financial values that are inputs to the accounts. This is important to investor confidence in accounts.
3. The Financial Reporting Council has been responsive to concerns from the audit profession, preparers of accounts and investors as to the impact of prevailing economic and market conditions on audit judgments, including circumstances in which audit opinions might need to be qualified. A number of elements of guidance have been issued. We support their efforts. The role of audit committees will also be crucial. They must work closely with the auditors, especially where there are difficult judgments to be made. Diligence on the part of the independent non-executive directors, who are the members of these committees, and quick responsiveness to signs of difficulties, can add materially to the ability of the company and its board to address matters at an earlier stage and take action to mitigate problems. The provisions of the Combined Code

suggest that there should be a separate section in the annual report to describe the work of the audit committee in discharging its responsibilities. Currently many of the descriptions have a boiler-plate quality and are of limited usefulness. We believe that there is now a strong case for improving transparency in this regard and moving towards generally accepted guidelines for audit committee reporting.

4. **Q1.2 Credit rating agencies** have played an aggravating factor in the banking crisis, notably through their approach to rating structured finance such as sub-prime mortgage backed securities. Their closeness to issuers has given the appearance, whether justified or not, of a symbiotic relationship with originators in the development of products which the agencies have then gone on to rate. The agencies have tended to hoard information, and their financial modelling has lacked transparency.
5. We agree that these issues need to be addressed but we are wary of the current EU Regulation proposal because it is excessively prescriptive and adopts a protectionist and extraterritorial approach. The market for debt securities is a global one, and rating agency reform needs to be considered on a global basis through a tougher IOSCO code, supported and monitored by all the world's main regulatory agencies.
6. We also strongly believe that the key to improvement resides in measures to make the information used by ratings agencies accessible to all, so that investors, or truly independent analysts working for them, can reach their own judgments. The core problem is that those responsible for the issue and sale of securities have withheld relevant information and prevented it reaching the market. The credit rating agencies have a vested interest in maintaining this exclusivity.
7. Addressing this would be more helpful than formal regulation of the agencies themselves. Such regulation will tend to increase rather than reduce investor reliance on ratings because the market will assume that a rating brings its own seal of quality. Insurers as large institutional investors tend to make their own credit judgments, sometimes indeed betting against that of the rating agency. They have not been major buyers of structured financial instruments and do not wish to see reliance on ratings increased in this way. This should be the principal focus of the regulators' approach.
8. It would help if the regulatory authorities were systematically to examine their own reliance on ratings as a supervision tool, and to eliminate it wherever possible. By regulating agencies, the authorities also need to be aware that they will themselves be held responsible for any future ratings failures.
9. **Q1.3 Hedge funds** should not be seen as a cause of the banking crisis. However, some funds have been significant investors in innovative

financial instruments. This may have been relevant to the build-up of financial imbalances, and to the way in which the banking crisis has played itself out.

10. Prior to the banking crisis we had already made our view clear that the hedge fund industry would benefit from material improvements as regards transparency to investors, and that self-regulatory responses to address these issues were desirable. In the UK this has been spearheaded by the Hedge Fund Standards Board. Understandable desires to impose regulatory solutions should be tempered, and in the first instance, due encouragement should be given to the sector to continue to seek enhancements to transparency, and improved adherence to best practice.
11. In practice, the impact of market turmoil on the hedge fund industry's business model has been considerable. Significant consolidation in the sector is likely. The priority that investors give to improved transparency and to a thorough understanding of funds' prospects and risks will contribute to a high level of adherence to best practice standards.
12. Q1.5 Much recent concern around passporting relates to the **compensation arrangements** which apply in the event of the failure of a firm operating in the UK. The arrangements are different in insurance from banking.
13. In banking, compensation is the responsibility of the home state rather than of the UK authorities (although an incoming firm can elect to 'top-up' if the compensation available through its home scheme is less than that provided by the Financial Services Compensation Scheme (FSCS)). However, in the case of insurance, the UK authorities require all insurance firms based in another member state operating in the UK under passporting arrangements to become members of the FSCS. This means that, if such a firm were to fail, UK consumers would be protected by the FSCS.
14. This situation arises because there is not currently an EU directive requiring member states to have an insurance guarantee scheme (IGS). However, the EU Commission is likely to bring forward a directive requiring all member states to establish an IGS within the next year or so. The ABI supports such a directive in principle. However, it is essential that it makes adequate arrangements to protect consumers where firms operate under passporting arrangements without imposing an undue burden on the firms contributing to the scheme.
15. Q1.7 UK insurers are subject to a strong **prudential regulatory regime** which has been put in place over the past few years and which ensures that they have adequate reserves and are strongly capitalised. We do not, therefore, believe that concerns about the adequacy of banking regulation should be read across to insurance.

16. We believe that the current insurance regulatory regime is a considerable improvement on previous regulatory practice. In particular the introduction of the Individual Capital Assessment (ICA) has required insurers to consider carefully the risks faced by their business and to ensure that they have sufficient resources. This process enables the FSA to challenge a firm's own assessment and impose additional capital requirements where necessary. The proposed Solvency II regime is very similar to the FSA's current approach.
17. A particular concern in relation to banks is the difficulties caused by a sudden withdrawal of liquidity. This is much less of a concern for insurers, where cash-flows tend to be predictable and particularly in the case of life insurers, liabilities are long-term in nature. We do not, therefore, believe that additional regulation is needed for insurers in this area.
18. The ABI therefore believes that, in the light of the FSA's current approach and the forthcoming move to Solvency II, there is no need for additional significant changes to the regulatory regime for insurers.
19. Q1.11. We do not believe that the press should be subject to particular **reporting restrictions** during banking crises, as these restrictions would be difficult to operate.
20. All journalists have a duty to report responsibly. This applies particularly in financial markets. That duty does not extend to self-censorship in order to protect the market from sharp movements. Journalists cannot decide for themselves what to suppress. If they have information that they know to be both correct and relevant, they must report it or be party themselves to market distortion.
21. It is a different matter for those who are the source of leaks of price-sensitive information. The law requires such information to be released in an orderly way through regulated channels, and not dribbled out through the press. It appears to have been repeatedly broken by those initiating leaks during the current crisis. This is market abuse. It has been damaging to market confidence, and action should be taken against the culprits.
22. Q1.14 Our Association believes that **short-selling** has an important role in market efficiency, through its contribution to liquidity and price discovery. We believe that the restrictions on short-selling of financial stocks imposed last year were right as a temporary measure but welcome the fact that they have been lifted. We do not consider that short-selling has been a cause of the banking crisis, or the demise of particular institutions within the sector. Indeed, the share prices of some affected institutions continued to decline markedly, even after the ban on short

selling was imposed. Markets do, however, require appropriate transparency. Securing improvements in this regard appears to be the most sensible way forward. An appropriate transparency regime would provide a safeguard that would promote greater confidence in the role of short-selling. This would provide an appropriate basis for relaxation in due course of the current restrictions.

### **Protecting the taxpayer**

23. Q2.4 The government's **intervention in the banks** aimed rightly at preserving the stability of the financial system. But we agree that the Government should not become a long-term holder of bank shares. The priority must now be to create value in these institutions so as to create scope for divestment at a reasonable return to the taxpayer. As a shareholder, the Government should promote sounder risk management and responsible lending on commercially viable terms. It should not seek to use its position to force the banks to engage in lending that is un-commercial or has excessive risk, not least as this will reduce the ultimate exit value and lead to a cost to the taxpayer.
  
24. Q2.5 We broadly agree with the mandate of the **UKFI** as set out in article in the Financial Times (*Mandate to protect taxpayers investment*) on Friday 14 November 2008 by its chairman and chief executive. We agree that the UKFI should operate as a responsible shareholder seeking to maximise the sustainable value of the banks. The UKFI's relationship with the part-nationalised banks should be on a commercial basis at arm's length. As such, the UKFI must seek to manage its investments, not manage the day-to-day operations of these banks. As a significant shareholder the UKFI should, as any responsible investor already does, enter dialogue with the boards and executive teams and hold them to account for their decisions. This dialogue should be conducted in such a way as to recognise the overarching aim of value creation.

### **Protecting consumers**

25. Q3.2 **Some commentators on the credit crunch have argued that banks should be barred from undertaking both retail and commercial banking on the one hand and investment banking on the other, as was the case under the now-repealed Glass-Steagall Act in the US. This does not seem an appropriate solution to us, since the two parallel markets could never exist in complete isolation from one another and there would always be a potential systemic risk in investment banking. However, in the light of the crisis, it would seem wise for banks to review at regular intervals the range of activities they undertake to ensure that they are appropriate for achieving long term financial stability and delivering sustainable returns to shareholders.**

26. **Banks clearly share some of the characteristics of a utility, particularly their role in operating payment systems. However, it does not follow from this that banks should be prevented from operating in related areas provided that appropriate regulatory requirements are in place and the risks are understood and effectively managed.**
27. **Many ABI members are subsidiaries of banking groups and, on the other hand, a number of ABI members have banking subsidiaries. From this it is clear that many financial services companies believe that there are synergies and opportunities for diversification between banking and insurance (and also asset management).**
28. **In practice, financial services groups operating in both the banking and insurance sectors will do so through separate subsidiary companies. There are regulatory rules (set by the FSA but based on the Financial Conglomerates or Insurance Groups Directives) which ensure that these companies have sufficient capital both individually and at group level, ensure that capital cannot be double-counted within the group and maintain restrictions on transfers from one part of the group to another. These requirements allow these different businesses to be operated in such a way that the interests of the customers of each business are protected.**
29. **Q3.3 The extent to which there is further consolidation within the retail financial services sector should be a matter of commercial judgement for firms and their shareholders.**
30. **However, it is very important that any such consolidation does not give rise to competition issues. It is vital that there remain enough banks operating in the UK retail market to provide consumers with sufficient choice of banking services. It is also important to note that sales through banks are an important distribution channel for many insurance products. Therefore, over-consolidation in the banking sector will result in less choice for consumers of insurance products as well as for banking.**
31. **Q3.5 The ABI strongly supports the provision of compensation to consumers through the Financial Services Compensation Scheme (FSCS) when UK firms (including the UK subsidiaries of overseas firms) become insolvent. These arrangements include compensation for customers of UK firms operating in another member state either through a branch or passporting arrangements.**
32. **However, we do not think it appropriate that the UK FSCS is extended to provide cover to UK citizens investing funds outside the UK under other circumstances. In these cases compensation should be provided under the scheme(s), if any, operating in the relevant jurisdiction. The FSCS is funded by levies on the UK financial**

services industry, and it would be inappropriate for the UK industry to pay for failures in another jurisdiction.

33. Investors need to be clear what arrangements exist in any jurisdiction in which they are considering investing. The nature and coverage of any schemes, and the risks involved, should be explained to investors.
34. Much of the concern in this area has been in relation to the position of the Isle of Man and the Channel Islands. These are not part of the UK and have separate regulatory and tax regimes. The ABI, therefore, does not think that it would be appropriate for the UK FSCS to be extended to these jurisdictions. However, the ABI believes that there is an important role for the financial services industry in these territories and welcomes the current review announced in the Pre-Budget Report.
35. Q 3.6 The ABI strongly supports the existence of industry-funded compensation for consumers through the FSCS. This is important for consumer confidence and also supports competition through weakening barriers to new entrants.
36. However, there is also a danger that if deposit protection (and compensation for insurance and investments) is set at too high a level then it will give rise to moral hazard. In these circumstances firms will have no incentive to manage risks - consumers will be attracted to accounts paying the highest interest, or in the case of insurance the cheapest policies, safe in the knowledge that they will not lose out in the event of their provider becoming insolvent. This will also allow reckless firms to take market share from well-managed competitors.
37. The ABI, therefore, believes that there must be limits on the level of compensation available. The current levels seem to us to provide a reasonable level of protection while maintaining an incentive on firms to take proper account of the risks.
38. It is also important that compensation levels are properly balanced between sectors to ensure that these do not provide a competitive advantage for one type of product over another. Once again, we believe that the current levels of available compensation achieve this but this requirement should be kept in mind when considering any changes to the current limits.
39. The ABI remains particularly concerned about the cross-subsidy arrangements recently introduced into the FSCS. We believe that recent events in the banking sector have shown that it is entirely inappropriate for there to be any potential for cross-subsidy between deposit protection and other parts of the financial sector

**due to the risk of contagion and the uncertainty generated for firms and their customers about the potential costs of paying any cross-subsidy. The existing cross-subsidy arrangements should, therefore, be dismantled. The concerns over liquidity which constituted the rationale for these arrangements has in any case become obsolete given that the FSCS will, once the current Banking Bill becomes law, be able to borrow from the National Loans Fund.**

#### Protecting shareholder interests

40. Q 4.1 It is a vitally important point of principle that companies are run on behalf of all shareholders and that all shareholders have the same rights, which they can use in pursuit of their **governance** responsibilities to the company they own. Whether investment is made by governments acting directly, as in the case of UK Government recapitalising some of the major banks, or by sovereign wealth funds (SWFs) with an avowedly arm's length relationship and investment value objective alone behind their involvement, it is important that the same considerations should apply.
41. We strongly support the principle that directors should represent, and be elected by, all shareholders, notwithstanding any special arrangements where there is a shareholder with a substantial stake. The important point is that such arrangements must be in the interests of the company as a whole, and that normal due process as embodied in the Combined Code for recommendations and nominations to be made by the Nomination Committee is respected.
42. We understand the UK government's desire to ensure that the banking sector as a whole maintains its lending to creditworthy borrowers during the economic downturn. However, this approach should be distinct from its governance approach to individual institutions in which it has an interest. As stated above, this should be driven by the objective of generating value for the taxpayer.
43. We support the government's open approach to the investments of SWFs, but we believe it is important that SWFs exercise their voting rights in a considered and responsible way, just as other long term investors seek to do. Since good governance generates value over time, this will also be in their interest and that of their beneficiaries.
44. Q4.2 Insurers as investors recognise the responsibilities of shareholders to ensure that companies in which they invest are properly managed. The ABI's activities in **corporate governance** reflect both members' role as long term shareowners in their own right and also their responsibility to policyholders who depend on the investment return.
45. The government has acknowledged that institutions have made strides forward in recent years, but it is clear that more could be done to improve the techniques and approaches to dialogue. We are keen to work on this,

with particular focus on improving mutual understanding between independent directors and shareholders, how they interact at times of corporate stress, and on ensuring that dialogue appropriately addresses key issues such as risk management.

46. We also wish to work with companies and others to promote greater focus on long-term investment issues. Partly because of the ambition of brokers to generate fee income from trading, analysts have tended to place great stress on the impact of short-term developments, including quarterly financial statements. It is now clear that the desire for short-term profit encouraged some financial institutions to take excessive risks, which subsequently led to serious losses. We need to shift the culture away from this. This objective will not be achieved through regulation, but the aim of introducing a longer term perspective should be an important priority for dialogue between shareholders and companies.
47. Dialogue between companies and shareholders is not guaranteed to work, however. Ownership of UK equities has become more fragmented in recent years with the insurance industry now owning only around 15 per cent of the market and pension funds somewhat less. With other owners sometimes less concerned about governance, this makes it easier for companies to override efforts by concerned shareholders to achieve change. It is important therefore that there is more consensus in the shareholder community about the need to hold Boards to account.
48. It is vitally important that corporate engagement, especially on corporate governance and sustainability issues, is integrated effectively into the investment management processes. Such engagement is resource intensive. Therefore, beneficiaries and their representatives, such as pension fund trustees should ensure that appropriate resources are available.

*January 2009*

### **Memorandum from BDO Stoy Hayward**

#### **Banking Crisis**

We welcome the opportunity to contribute to the debate on the Banking Crisis. We note that the committee has already considered the role of accounting standards in the current crisis and welcome the statement by the G20 group that supports the need for a global approach to standard setting. The current crisis is an economic crisis and not an accounting crisis. It is also global in scale and not limited to the United Kingdom.

The role of the auditor is to form an independent opinion as to whether financial statements prepared by the directors, present a true and fair view of the financial performance and financial position of an entity at a point in time.

There is a requirement for both directors and auditors to consider the ability of an entity to continue as a going concern at the time the accounts and audit report are issued which requires looking forward for a period of at least 12 months. In the current crisis the consideration of going concern will have significant implications for all stakeholders.

The FRC published guidance for directors and auditors to assist in the current crisis. Although this guidance did not introduce any new requirements we believe that the publication of the guidance will be helpful to preparers and auditors in the current environment. It is clear from the guidance that directors and auditors will need to carefully consider the forecasts prepared by the management and in particular the assumptions underlying those forecasts when considering the ability of a company to continue as a going concern. Any material uncertainties that a company faces will need to be considered and disclosed and in the event that they lead to a significant doubt regarding going concern these will need to be fully explained in the accounts and the auditors may be required to draw attention to them in their report.

The auditors will be required to exercise professional judgement on the issue of going concern; it will not be acceptable to issue audit reports that contain standard paragraphs referring to the current economic uncertainties.

The availability of funds will be critical for many businesses; in particular it will be important for those successful businesses that rely on bank funding to be able to ensure that they have access to funding going forward. We are not advocating furthering poor lending decisions to bad businesses but rather that for sound businesses which may nevertheless be subject to uncertainties, banks provide committed facilities to support such businesses going forward. We believe that without committed funding from banks or other providers of finance boards will be forced to disclose the uncertainties that businesses face in obtaining finance and that auditors may need to provide additional disclosures in audit reports. In some cases such disclosures could lead to the withdrawal of credit which in turn could lead to further failures and a deepening of the crisis.

In order to assist banks in making available committed funds the on going actions of the Tripartite authorities to support the banking system though, for example, the continuation of the Special Liquidity Scheme will be essential.

We consider that auditors have been seen to have discharged their responsibility appropriately to date in the current crisis. In this context we note that the Public Oversight Board report to the Secretary of State noted that the quality of auditing in the UK is fundamentally sound. In particular the recently published Audit Inspection Unit ("AIU") report stated that overall the AIU considered that the firms responded appropriately and on a timely basis to the significant challenges arising as a consequence of the credit crisis, although we acknowledge that the inspection period would not have covered the December 2007 reporting period and therefore did not address challenges arising from the more recent turmoil in the markets.

There will be lessons to learn from the crisis and areas to consider include whether there is a need to enhance reporting on internal controls, and whether entities should consider enhanced reporting of the business models they adopt and the strategic risks they face.

The UK has a requirement under the combined code, for boards to maintain a sound system of internal control to safeguard shareholders' investments and company assets and need to annually conduct a review of the system of controls and to report to shareholders that they have done so. Further guidance is given in the Turnbull guidance on Internal Control. The guidance is consistent with the UK approach of "comply or explain" to Corporate Governance, requiring narrative reporting on the processes adopted by the board for reviewing internal control, an acknowledgement by the board of their responsibilities and confirmation of any actions taken. Other jurisdictions have more detailed requirements regarding the reporting on internal controls and the auditors' responsibility to review their effectiveness. This may be an area for consideration but the cost effectiveness of any changes should be carefully considered before implementation, particularly in light of the fact that as this is a global crisis, additional reporting requirements may not be the answer.

In our view, an important area of focus should be the quality of the strategic risk review by businesses and the measures they implement to manage and mitigate such risk. Boards need to have the appropriate expertise and the right information to identify and fully understand the strategic risks facing the entity if they are to manage such risks effectively. There is a fine balance to be struck to ensure internal controls are appropriate and ensure risk taking is undertaken in a responsible manner but not to stifle entrepreneurial spirit.

An investigation into the companies that have failed focused on what disclosures, if any, would have assisted shareholder understanding would be useful.

In respect of more narrative reporting by boards we note that there have been calls from some investors for enhanced reporting by audit committees and for more comprehensive reporting of the fundamental business models adopted by entities; this is something that may warrant further thought although again the cost effectiveness of any new reporting requirements would need to be considered. In considering any enhanced reporting processes it may also be useful to focus on the reward and remuneration practices adopted by entities.

The Financial Reporting Council's project on competition and choice has the objectives of providing increased choice of auditor for public interest entities, reducing the risk of an existing firm leaving the market without good reason and reducing costs of uncertainty and disruption in the event of a firm leaving the market. Through adopting the project there is recognition that the existence and effective operation of a high quality audit market is vital for the successful operation of the UK economy. We support the objectives of the project and note that the current crisis underlines the need for a robust and competitive audit market that provides adequate choice for public interest entities.

*January 2009*

## **Memorandum from the Association of Mortgage Intermediaries**

### **Executive Summary**

1. The Association of Mortgage Intermediaries (AMI) is pleased to have this opportunity to contribute to the Treasury Committee inquiry on the banking crisis. We are submitting the following documents to support our written evidence:

- 'Fixing the Crunch' - Steps toward a remedy for the mortgage market's credit crunch
- The Value of Mortgage Advice

2. AMI has fully supported the Government's intervention in the mortgage market to date, and we welcome the pre-Budget Report measures designed to help homeowners and SMEs. We also welcome Sir James Crosby's recommendation for guaranteed securitisation for the mortgage market and believe this should be implemented as soon as possible.

3. While we believe the nationalisation of some UK banks was necessary at that particular moment in time, we have concerns around the potential for decreased competition arising from the concentration in mortgage lending.

4. UK citizens have benefited from a decade of competition in the mortgage market that saw rapid product innovation (for example, flexible and offset mortgages), falling margins (delivering lower mortgage rates), and the arrival of foreign financial institutions who brought new capacity to the market. In turn this assisted in the growth of the UK economy and the flexibility of the labour market as it became easier to move house in search of a better job. The dream of becoming a home-owner was realised by many millions of people in this period. However, we recognise that the market had become over-heated and wish to see a return to more stable patterns of lending which support the natural desire to own a home of one's own, but protect consumers from entering into unsustainable levels of debt.

5. We believe it is vital to ensure consumers have access to professional mortgage advisers who are on their side, acting in their best interests and ensuring they select the most suitable and competitively priced product for their individual needs. Consumer demand for mortgage advice has grown through 2008, as consumers have understood the need to consult an adviser who can act in their best interests during difficult periods. It is therefore crucial that lenders provide open access to their mortgage lending through intermediaries (rather than simply favouring branch-based business) to ensure consumers have the best possible access to suitable products.

6. We acknowledge that intermediaries have come under the spotlight in 'irresponsible lending' discussions. However, it should be remembered that it is lenders who set the affordability rules and who ultimately decide whether to grant a loan. Recognising that consumers should always borrow within their

means, they look to the adviser to guide them through the plethora of mortgage products available and to help them understand the long-term financial impact of buying a home and taking out a mortgage.

## **Introduction**

7. The Association of Mortgage Intermediaries (AMI) is the trade body for those firms who offer advice to borrowers seeking a mortgage. Intermediaries account for approximately 70% of the mortgage market and advised on a total of £250 billion in 2007. Mortgage intermediaries offer their clients a convenient, professional service, helping guide them through the vast array mortgage products available from the mortgage market.

8. AMI was the first of the trade bodies to publish a set of proposals on remedies to the credit crunch, in the form of our April 2008 White Paper entitled 'Fixing the Crunch', a copy of which we have included in our submission to the Committee. We strongly felt at the time of publication that the mortgage market had passed the stage where it was able to heal itself and find a resolution to the current crisis. That is why we took the decision to publish a White Paper calling for outside intervention. We discussed these proposals at meetings with Sir James Crosby, the Bank of England, the Treasury and other policy makers.

9. The White Paper set out the causes of the credit crunch as seen by the mortgage intermediary community, stated our concerns, and provided a series of starting points for addressing the market's problems. It addressed such issues as alternative sources of Capital, the role of the Bank of England, a new Gold Standard for Mortgage Backed Securities and traditional buyers of Mortgage Backed Securities, and is submitted to the Committee as part of our written evidence.

10. Also attached to this submission is a research piece entitled 'The Value of Mortgage Advice', which has been compiled by independent financial services research company NMG. The study details the financial value consumers can receive from gaining independent mortgage advice. In some cases it has been proven that consumers can save £1,830 per year compared with going direct to lender<sup>10</sup>. In the current financial climate, we believe it is important to put a financial value on the benefits obtained by the intermediary community for consumers. Not only may intermediaries have access to the widest product set, they find their clients the most suitable product for the individual's circumstances, and find it at the most competitive price.

11. There is an obvious demand from the consumer for high quality mortgage advice, especially during difficult economic times, and our members endeavor to fulfill their clients' needs against an ever-changing backdrop.

## **Protecting the taxpayer**

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<sup>10</sup> Mortgage Value of Advice P.17 – This is based on the average loan size of £152,468 and a consumer being sold an SVR mortgage by a direct sales channel.

*The Government's recapitalisation programme, and part-nationalisation of major high-street banks.*

12. AMI fully support the Government's steps taken to date to recapitalise and part-nationalise major high-street banks. However we are somewhat concerned that the Special Liquidity Scheme (operated by the Bank) is too narrow and does not provide sufficient access to secondary and smaller lenders. We would like to see wider access allowed, for a wider range of securities, and thought should also be given to the cost of capital made available.

13. AMI also strongly welcomes Sir James Crosby's Final Report which proposes temporary guaranteed securitisation, and we agree with his comments that "unless and until banks get access to attractively priced sources of funding the shortage of mortgage finance will endure". Not only are AAA mortgage backed securities still relatively safe and could actually be profitable for the Government, but the cost of funding these instruments would be attractive to all banks so there would be no stigma in using them. We urge the Government to implement these recommendations as soon as possible.

14. The table below sets out historic and projected Gross Mortgage Lending on residential properties. The significant contraction is not due to lack of consumer demand but is caused by the loss of institutional financial liquidity and limited capital availability driving lack of funds.

<b>Time Period</b>	<b>Gross Lending (£)</b>
2006 H1	160bn
H2	185bn
2007 H1	174bn
H2	186bn
2008 H1	149bn
H2 (projected)	109bn
2009 H1 (projected)	72bn
H2 (projected)	73bn

*Source: CML*

15. Should there be no Government action to increase the amounts of funds available in 2009, then we consider this will lead to continuing repossessions at higher levels than are expected and damage to the wider economy as markets continue to decline and slow. House prices will continue to decline, for longer than might be required otherwise. We are concerned that this will lead to a general decline in the state, and value, of the current housing-stock, as home owners who would consider buying a new property are deterred by house price falls, but do not invest in their own property given their inability to release equity from it to pay for an improvement or extension, given its fall in value (or scarcity of mortgage funds).

*The nationalisation of Northern Rock and Bradford & Bingley and the competition impact of further consolidation within the retail financial services sector.*

16. Whilst the nationalisation of Northern Rock and Bradford & Bingley were clearly important for economic stability at the time, in the long term we are concerned about the dangers arising from the concentration of lending. We would like to see a formal review date set when the competition effects will be reviewed by the Office of Fair Trading (OFT).

17. We understand that a significant number of lenders have no capacity to commit to new lending and therefore it is likely that in 2009 over 90% of first time mortgage lending will be done through just six banks.

18. Our research paper ‘The Value of Mortgage Advice’ shows 49% of consumers who purchased a mortgage on a direct basis did so from their own bank/building society without considering any other option. A further 39% contacted no more than three lenders. These behaviour patterns significantly reduce the likelihood of finding the most appropriate and competitively priced mortgage for the individual’s own circumstances.

19. Consumers who buy direct tend to purchase higher margin products than those who consulted an intermediary, as FSA figures reveal. If consumers are not to be penalized by paying more for a mortgage than they need to, lenders should be encouraged to respect consumers’ desire for advice and work with the intermediary community.

## **Protecting consumers**

### *The role of mortgage advisers*

20. The report ‘The Value of Mortgage Advice’ shows clear evidence of the ways in which independent mortgage advice adds value to the outcomes achieved by the prospective borrower. These can be demonstrated in terms of cost savings (such as in product availability and rate payable) or in terms of the quality of advice given and the overall levels of satisfaction with the mortgage process. The positive effect of advice from the intermediary is reflected in the levels of satisfaction with the advice received by borrowers and in their willingness to recommend their adviser. Our research proves that those consumers who used an intermediary benefited from a lower mortgage payment by as much as £1,830 per year.

21. Intermediaries provide a flexible, low-cost channel to lenders, as they only pay for completed business at the volume, type and quality they determine. Independent advisers offer their clients the opportunity to pay by a fee or for the adviser’s costs to be met through a commission payment from the lender (which is fully disclosed).

22. During the banking crisis, lenders and intermediaries have both been criticised for 'irresponsible' mortgage lending. However it is lenders who set the affordability and credit rules that intermediaries must conform to.

23. Consumers look to their advisers to guide them through the thousands of mortgage products that have been available, and to help them understand how much they can afford to borrow over the longer term. Lenders have access to credit scoring systems that hold the complete histories of potential borrowers, so unlike intermediaries, they are in a position to decide if a client meets their credit standards – intermediaries only have the information provided by the client, in making a recommendation. Intermediaries are denied access to lenders Credit Reference Agencies (CRAs) systems; the consequence for consumers could be multiple footprints being left on credit files as both the lender and intermediary search for the same information.

24. Mortgage intermediary firms are adversely affected by the credit crunch and the wider economic downturn. Crosby acknowledges in his Final Report that in recent years intermediaries have been the major force for competition within the market both in terms of extending access and achieving better value for consumers. However while intermediaries are keeping market share they are losing volume in a rapidly declining market. Potential borrowers still want mortgage advice; but there will be fewer firms to offer it. Firms with customer-focused, advice-driven business models are likely to survive this economic turbulence, though numbers will fall from around 30,000 mortgage intermediaries to 15-20,000. In the future we will see a smaller, leaner industry but the remaining firms will have the best staff and will be stronger and better diversified. Last September, 71% of larger firms had activities beyond mortgage broking alone, by March, 85% did.

*The Government's aspirations for assisting customers, and small businesses, in financial difficult*

25. AMI welcome the extremely positive steps taken in the Pre-Budget Report to freeze corporation tax, cut VAT and encourage lending to SMEs. These government measures were rightly designed to keep UK SMEs afloat during these difficult times. The decision to reduce VAT from 17.5% to 15% should lessen the tax burden to borrowers and encourage homeowners to continue to maintain or renovate their home, thus helping to minimise a reduction in the value of housing stock in the UK.

26. The housing market should also benefit from an increase in the maximum mortgage amount for ISMI. Additionally the mortgage rescue scheme will be extended to cover those at greater risk as a result of taking out a second mortgage, while major mortgage providers have agreed to wait three months after falling into arrears before initiating repossession proceedings. These measures combined should help allow more people to stay in their own homes.

27. We also welcome the creation of a new Lending Panel to monitor lending to both businesses and households. While several lenders have already been invited

to sit on the Panel, we believe the lender element, whilst clearly crucial, is only one side of the equation, and this stakeholder circle therefore needs to be widened to include consumer groups and the intermediary community.

28. Additionally AMI is pleased that the Government has answered our call to help support SMEs. We particularly welcome the introduction of tax breaks for businesses caught up in the financial turmoil. Small and medium sized firms in all sectors have been affected by the financial turbulence, and financial services in particular have borne the brunt of this storm, which is why this measure to reduce the tax burden for small business is the right thing to do.

29. Other measures announced by the Chancellor that will assist SMEs include the Government's commitment to keep banks lending to small businesses, the announcement that small firms can have "as long as they need" to pay their taxes to HMRC, and the establishment of a temporary Small Business Finance Scheme which will allow SMEs to borrow between £1,000 and £1m at more flexible terms than before, helping ease cashflow difficulties firms may face.

30. However, while we welcome many of the measures announced in the pre-Budget Report, we would have liked to see a review of business rates deferred as this may offset any reductions in corporation tax. We are also disappointed that we will need to wait until the Budget before help is provided to see Sir James Crosby's recommendations enacted.

*January 2009*

## **Memorandum from the UK Financial Reporting Council (FRC)**

### **Introduction**

1. This paper responds to an invitation dated 11 December 2008 for the submission of written evidence in connection with the Treasury Committee's inquiry into the banking crisis.
2. This structure of this paper is as follows:
  - a. Key Points (paragraph 3);
  - b. Executive Summary (paragraphs 4-11);
  - c. Background information on the Financial Reporting Council (FRC) and its relevant operating bodies (paragraphs 12-24);
  - d. The purpose, and intended audience, of statutory audit (paragraphs 25-34);
  - e. The findings from independent audit monitoring (paragraphs 35-46);
  - f. Going concern in the current economic conditions; (paragraphs 47-52); and
  - g. The importance of Corporate Governance, including audit committees (paragraphs 53-67).

### **Key Points**

3. The key points the FRC wishes to highlight from this paper are:
  - The FRC is an independent regulator, supported by a range of statutory and non-statutory powers which contribute to confidence in corporate reporting and governance;
  - Public confidence in the operation of the capital markets depends in part on the credibility of corporate reports produced by Boards of Directors. The primary purpose of an audit of the financial statements is for the auditor to provide independent assurance to the shareholders that the directors have prepared the financial statements properly. The information required to be included in financial statements is likely to be useful to financial services regulators but is not designed with their specific needs in mind;
  - The role and powers of the auditors of banks differ from, and are more limited than, those of financial services regulators. Any proposals to extend the role of auditors would need to be examined carefully to assess their cost-effectiveness and impact on the UK's competitiveness;
  - The FRC and its operating bodies have a role to play in promoting confidence in audit through the establishment of standards and independently monitoring the quality of audits of listed and major public interest entities. Findings from independent audit inspection

support the view that audit in the UK is fundamentally sound while highlighting some important areas where further improvement by the audit firms is required;

- Directors of all companies need to ensure that they prepare thoroughly for their assessment of going concern and make appropriate disclosures. The current economic situation does not, of itself, mean that a material uncertainty exists about an entity's ability to continue as a going concern, although the reduced availability of credit from banks makes it more difficult for directors and auditors to satisfy themselves on the use of the going concern basis of accounting. The FRC recently published guidance for directors and auditors about going concern; and
- An entity's corporate governance arrangements, including in particular the role of its audit committee, impact the quality of financial reporting and the effectiveness of independent audit. The FRC has recently updated both the Combined Code and its Guidance on Audit Committees and has published an audit quality framework.

## **Executive Summary**

### **The FRC**

4. The FRC is the UK's independent regulator responsible for promoting confidence in corporate reporting and governance. Working mainly through its operating bodies, and supported by a range of statutory and non-statutory powers, the FRC's aim is to strengthen confidence in corporate reporting and governance by promoting high-quality corporate governance, corporate reporting, auditing and actuarial practice, and by promoting the integrity, competence and transparency of the accountancy and actuarial professions. Following extensive consultation, in February 2008 the FRC issued the *Audit Quality Framework* designed to support effective communication between auditors, audit committees, preparers, investors and other stakeholders on audit quality (paragraphs 12-24). The FRC and its operating bodies have played an active role in monitoring the accounting and auditing implications of the current financial crisis and have taken a range of actions (paragraph 24).

### **The purpose, and intended audience, of statutory audit**

5. The purpose and intended audience of statutory audit is established by legislation. The primary purpose of an audit of the financial statements is for the auditor to provide independent assurance to the shareholders that the directors have prepared the financial statements properly. As required by legislation, the auditor issues an opinion as to whether or not the financial statements give a true and fair view (paragraphs 27-28) and are in accordance with the relevant accounting framework.

6. The role and powers of auditors of banks differs from, and are more limited than, those of the financial services regulators. Whereas the role of the auditor is primarily to express an opinion on a bank's financial statements, financial services regulators have extensive powers to influence the behaviour of banks. These powers include approval of significant shareholders and senior management, restrictions on the scope and scale of a bank's operations and requiring banks to hold minimum levels of capital. The information required to be included in financial statements is likely to be useful to financial services regulators but is not designed with their specific needs in mind.

7. Any proposals to extend the scope of statutory audit would need thorough analysis and debate to assess their cost-effectiveness and impact on the UK's competitiveness and to avoid unintended consequences.

### **The findings from independent audit monitoring**

8. The POB's Audit Inspection Unit ('AIU') inspects the quality of audit of economically significant entities. Inspections at the largest six audit firms are currently carried out annually and at the next three firms on a two year cycle. Inspections assess the quality of a firm's audit quality control procedures and their performance on a selection of individual audit engagements. In the year to 31 March 2008 the AIU conducted seven full scope inspections of large audit firms and reviewed 90 individual audits of major public interest entities. Some 25% of those audits were of entities in the Banking, Finance and Investment sector. Findings from those independent audit inspections support the view that audit in the UK is fundamentally sound with no systemic weaknesses while highlighting some important areas where firms need to make further improvements (paragraphs 35-46).

### **Going concern in the current economic conditions**

9. Current economic conditions provide particular challenges to all involved with annual reports and accounts. One consequence is expected to be an increase in the disclosure in annual reports and accounts about going concern and liquidity. Directors will need to ensure that they prepare thoroughly for their assessment of going concern and make appropriate disclosures. Auditors will need to ensure that they fully consider going concern assessments and investors and lenders will need to be prepared to read all relevant disclosures in annual reports and accounts.

10. The effect of the general economic situation at the present time does not, in itself, necessarily mean that a material uncertainty exists about an entity's ability to continue as a going concern or justify auditors modifying their reports to draw attention to going concern. However, the reduced availability of credit from banks in the current economic conditions makes it more difficult for

directors and auditors to satisfy themselves on the use of the going concern basis of accounting (paragraphs 47-52).

### **The importance of corporate governance, including audit committees**

11. The effectiveness of the UK's approach to corporate governance is important because an entity's corporate governance arrangements, including in particular the role its audit committee, impact the quality of financial reporting and the effectiveness of independent audit. The FRC publishes the Combined Code on Corporate Governance which sets out the standards of good practice in relation to such issues as board composition and development, remuneration, accountability and audit and relations with shareholders. The UK's primary approach to monitoring the behaviour of company boards rests with the company's shareholders through their response to the 'comply or explain' regime. The rationale for this is that, as one of the main purposes of good governance is to ensure that the board acts in the long-term interests of the shareholders, the shareholders should be the ones to judge whether the arrangements the board has put in place will achieve that objective (paragraphs 53-67).

### **About the Financial Reporting Council (FRC)**

12. The Financial Reporting Council (FRC) is the UK's independent regulator responsible for promoting confidence in corporate reporting and governance. Its functions are exercised principally by its operating bodies (the Accounting Standards Board, the Auditing Practices Board, the Board for Actuarial Standards, the Financial Reporting Review Panel, the Professional Oversight Board and the Accountancy and Actuarial Discipline Board) and by the FRC Board. The Committee on Corporate Governance assists the FRC Board in its work on corporate governance. The FRC has a range of powers, some of which have a statutory basis, and is sponsored by both the Department for Business, Enterprise and Regulatory Reform (BERR) and HM Treasury.

13. Confidence in corporate reporting and governance is a fundamental prerequisite for the effective functioning of the economy and financial markets. The FRC's aim is to strengthen that confidence by promoting high-quality corporate governance, corporate reporting, auditing and actuarial practice, and by promoting the integrity, competence and transparency of the accountancy and actuarial professions.

14. Among its responsibilities, the FRC:

- issues accounting standards in the UK and Ireland but, with the move to International Financial Reporting Standards ('IFRS'), is increasingly

focused on influencing the setting of standards by the International Accounting Standards Board ('IASB');

- seeks to ensure, through the Financial Reporting Review Panel (FRRP), that the annual accounts of public companies and large private companies comply with the requirements of the Companies Act 2006 and applicable accounting standards;
- sets auditing, quality control and ethical standards for auditors through the Auditing Practices Board (APB);
- monitors and, where appropriate, enforces the application of auditing, quality control and ethical standards by the Professional Oversight Board (POB) through its Audit Inspection Unit (AIU);
- operates an independent investigation and disciplinary scheme; and
- publishes the Combined Code on Corporate Governance and periodically reviews its operation.

15. Paragraphs 16 to 18 provide a summary of the FRC's key responsibilities with respect to auditing; more detail on the FRC, its operating bodies, and its aim and objectives is provided in Appendix A.

16. The APB establishes quality control, auditing and ethical standards for auditors to provide a framework for audit practice in the UK and the Republic of Ireland. The APB made the strategic decision in 2004 to base its auditing standards on International Standards on Auditing (ISAs) issued by the International Auditing and Assurance Standards Board (IAASB). It issued a new set of auditing standards (known as ISAs (UK and Ireland)) in December 2004 which reflected important improvements in key areas. These areas included identifying, assessing and responding to audit risks, including fraud risks, and quality control procedures for audits. The APB is currently consulting on when and how to update its standards to reflect a major improvement project, known as the "Clarity Project", soon to be completed by the IAASB. As part of the Clarity Project, ISAs on important topics such as accounting estimates, including fair value measurements and disclosures, group audits and related party transactions have been improved to reflect the latest developments and thinking. The APB has stated that, as the improvements made are designed to enhance audit quality, it believes there is merit in introducing these new standards in the UK and Ireland as soon as is practicable.

17. The APB also issues guidance in the form of Practice Notes and Bulletins to assist auditors in applying its standards to particular circumstances and industries and to address new or emerging issues. For example, a revised Practice Note on the audit of banks and building societies in the UK was issued, with support from the FSA, in January 2007 and updated draft guidance on auditing complex financial instruments was issued in December 2008.

18. The POB provides independent oversight of the regulation of accountants and actuaries by their respective professional bodies. It provides statutory

oversight of the regulation of the auditing profession by the recognised supervisory and qualifying bodies, and, through the AIU, monitors the quality of the auditing function in relation to economically significant entities. Under the Companies Act 2006 (Section 1224A), there are statutory provisions that prohibit the disclosure of certain information in the discharge of the POB's functions.

19. In November 2006 the FRC published a discussion paper, *Promoting Audit Quality*, which sought views as to whether, within the existing legal and regulatory framework, all appropriate steps were being taken to maintain and enhance the quality of audits and, if not sought views as to what more could or should be done.

20. The discussion paper set out the difficulties in determining audit quality due to a lack of a single agreed definition of audit quality against which actual performance can be assessed, the subjective nature of the auditors' opinion and the limited transparency of the underlying work performed and judgements made. As a result of these difficulties the FRC identified and consulted on the factors, or drivers, that determine whether a quality audit is undertaken.

21. The FRC identified five main drivers of audit quality as follows:

- The culture within the audit firm;
- The skills and personal qualities of audit partners and staff;
- The effectiveness of the audit process;
- The reliability and usefulness of audit reporting; and
- Factors outside the control of auditors affecting audit quality.

22. These drivers were confirmed during the consultation process and as a result the FRC published an *Audit Quality Framework*. In publishing the *Audit Quality Framework*, which is attached as Appendix B, the FRC hoped that stakeholders would find the consensus on what drives a high quality audit helpful. In particular the FRC hoped that the Framework would assist:

- Companies – in evaluating audit proposals;
- Audit Committees – in undertaking annual assessments of the effectiveness of external audits;
- All stakeholders – in evaluating the policies and actions taken by audit firms to ensure that high quality audits are performed, whether in the UK or overseas; and
- Regulators – when undertaking and reporting on their monitoring of the audit profession.

23. The FRC's feedback statement following its consultation on *Promoting Audit Quality*, together with all non confidential responses, can be found on its website [www.frc.org.uk/about/promotingauditquality.cfm](http://www.frc.org.uk/about/promotingauditquality.cfm) .

24. The FRC and its operating bodies have played an active role in monitoring the accounting and auditing implications of the current financial crisis. In particular:

- The FRC issued guidance for audit committees in December 2007 highlighting the challenges of corporate reporting and governance in the following year and issued updated guidance for audit committees highlighting challenges arising from the current economic conditions in November 2008;
- In November and December 2008 the FRC provided guidance to directors and the APB to auditors on going concern issues in the current climate (paragraphs 47-52);
- The ASB has actively supported the work of the IASB and EFRAG on fair value accounting issues, as well as monitoring and influencing UK attitudes. In October 2008, the ASB issued amendments to its standards on the reclassification of financial instruments following revisions to IFRS;
- During the year 1 April 2006 to 31 March 2007, the Panel reviewed the accounts of 16 banks reporting under IFRS, including retail and investment banks and finance subsidiaries of overseas banks and large UK retail companies. Points identified by the Panel indicated a need for refinement of some disclosures in certain cases rather than for significant changes. The issues raised varied between banks and there was no evidence of any systemic reporting weaknesses. During the year to March 2008, the Panel reviewed the accounts of 10 retail and investment banks reporting under IFRS. The Panel considered compliance with all applicable reporting standards. As in the previous year, issues raised varied between banks, and based on the information provided within the accounts and provided by entities in response to Panel queries, there was no evidence of systemic reporting weaknesses. Most of the points raised indicated a need for refinement of certain disclosures rather than significant changes in recognition or measurement policies;
- The FRRP announced on 9 November 2007 that its review activity in 2008 and 2009 would focus on the banking sector (and four other sectors). This work is progressing in accordance with the Panel's normal operating procedures. In its press notice of 30 October 2008, the FRRP announced that banking would continue to be a focus of its work for 2009 and 2010. The Panels work has not resulted in any restatements of prior period financial statements;

- The APB issued in January 2008 a Bulletin on ‘Audit issues when financial market conditions are difficult and credit facilities may be restricted’;
- The AIU responded to the heightened audit risk posed by the credit market turbulence by discussing with the major audit firms their preparations for ensuring their audit teams were adequately prepared for the risks relevant to the December 2007 reporting cycle, enhancing their risk based approach to the selection of individual audits for review and tailoring their work programmes to ensure increased focus on individual reviews on the relevant risks; and
- The FRC provided evidence to the Treasury’s Committee hearing on the role of accounting on the banking crisis.

### **The purpose, and intended audience, of a statutory audit**

25. Public confidence in the operation of the capital markets and in the conduct of public interest entities depends, in part, on the credibility of the opinions and reports issued by the auditor in connection with the audit of financial statements.

26. The directors of a company are responsible for the preparation of the Annual Report and the group financial statements in accordance with the relevant accounting framework and for ensuring that the financial statements show a true and fair view.

27. The purpose, and intended audience, of statutory audit is established by legislation. The primary purpose of an audit of the financial statements is for the auditor to provide independent assurance to the shareholders that the directors have prepared the financial statements properly. As required by legislation, the auditor issues an opinion as to whether or not the financial statements give a true and fair view, whether they have been prepared in accordance with the relevant financial reporting framework and in accordance with the Companies Act 2006 (and, where applicable Article 4 of the IAS Regulation).

28. In addition the Companies Act 2006 requires the auditor in preparing its report to carry out various investigations and report (by exception) when:

- Adequate accounting records have not been kept by the company;
- The company’s individual accounts are not in agreement with the accounting records and returns;
- The auditable part of the Directors’ Remuneration Report is not in agreement with the accounting records and returns; and
- The auditor has not received all the information and explanations which, to the best of its knowledge and belief, are necessary for the purposes of the audit.

29. Any proposed extension to the purpose and intended audience for statutory audit would require thorough analysis and debate if they are to avoid unintended consequences. In particular those proposing change will need to satisfy themselves on:

- The competence of the auditor to meet any new requirements;
- The costs involved;
- The exposure of auditors and others to liability risk;
- The need for legislation; and
- International considerations such as UK competitiveness.

30. In order to be eligible for appointment in Great Britain as auditors of companies, or of any of the other entities which require their auditors to be eligible for appointment as auditors under section 1212 of the Companies Act 2006, persons must be registered with a Recognised Supervisory Body (RSB)<sup>11</sup> recognised under that Act and must be eligible for appointment under the rules of that RSB. The Companies Act 2006 requires RSBs to have rules and practices as to the technical standards to be applied in company audit work and the manner in which those standards are to be applied in practice. Each RSB is also required to have arrangements in place for the effective monitoring and enforcement of compliance with those standards.

31. As stated above technical standards for auditing, quality control and ethics are set by the Auditing Practices Board. The APB comprises individuals who are eligible for appointment as company auditors and those who are not so eligible. Those who are eligible for appointment as company auditors may not exceed 40% of the APB by number.

32. The RSBs have adopted APB's standards and guidance and apparent failures by auditors to comply with APB standards are liable to be investigated by them. Auditors who do not comply with auditing standards when performing company or other audits make themselves liable to regulatory action which may include the withdrawal of registration and hence of eligibility to perform company audits.

33. APB's standards apply to auditors carrying out statutory audits of companies in accordance with the Companies Acts. This includes bank audits but the standards are not specific to bank audits. Rather the APB provides additional guidance to assist in the application of the generic standards to certain specialised industries. Over the years APB has issued, and kept current, specialist industry guidance for banks, insurance companies and investment businesses as well as a number of other sectors such as charities and pension schemes.

34. A number of ISAs (UK and Ireland) are of particular relevance to the audit of banks in the current economic climate. These include in particular, ISAs (UK

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<sup>11</sup> The Institute of Chartered Accountants in England & Wales, The Institute of Chartered Accountants of Scotland, The Institute of Chartered Accountants in Ireland, the Association of Authorised Public Accountants and The Association of Chartered Certified Accountants are Recognised Supervisory Bodies for the purpose of regulating auditors in the UK.

and Ireland) 220 on quality control, 315 and 330 in respect of risks and 545 on fair value measurements. While auditing standards are one factor in contributing to audit quality there are other important drivers as set within the FRC's discussion paper *Promoting Audit Quality* discussed below.

### **The findings from independent audit monitoring**

35. The Audit Inspection Unit (AIU), part of the Professional Oversight Board, is responsible for the monitoring of the audits of all listed and other major public interest entities. The audits of all UK incorporated companies with listed securities (both equity and non-equity securities) and other entities in whose financial condition there is considered to be a major public interest are within the scope of the AIU's work. A description of the entities within the AIU's scope for 2008/9 was issued in March 2008. The monitoring units of the RSBs are responsible for the monitoring of other audits within the scope of audit regulation in the UK (i.e. those outside the scope of independent inspection by the AIU). In addition to the Big 4 Firms, there are currently five other major firms undertaking more than ten audits within the AIU's scope and therefore subject to full scope AIU inspections, including a review of their firm-wide procedures, under statute. Other firms which have any audits falling within the AIU's scope are subject to periodic reviews of one or more such audits by the AIU and reviews of their firm-wide procedures by the monitoring unit of the RSB with which they are registered.

36. UK law which implements minimum requirements set out in European directives requires that the auditors of listed and other major public interest entities are monitored at least once every three years. However given their significance the AIU currently inspects the largest six audit firms in the UK every year and inspects other firms in scope less frequently as permitted by law.

37. The POB consulted on changes to the reporting arrangements for the AIU in June 2007 ("Reporting on Audit Quality Monitoring - Implementing a New Approach"). The results of that consultation and the Board's policy conclusions were published on 5 December 2007.

38. A key change to the reporting arrangements was that the AIU would no longer publish one annual report on generic themes and findings but rather high level public reports on individual audit firms. Such reports would only be published for those firms where the AIU had undertaken a full scope inspection. The content of these reports would be based on the findings set out in the AIU's more detailed private reports to the respective audit registration committees. This change marked an important development in increasing the transparency of the AIU's work. The first such reports were published on 8 December 2008 in respect of the AIU's 2007/8 inspection programme.

39. Another significant change was the introduction of new reports on individual audits reviewed by the AIU for those reviews which commenced after 1 January 2008. While these reports are addressed to the relevant audit engagement partner, the POB's expectation is that they will be provided by the

firms to the relevant client's senior executives and audit committee. This is a further important contribution to enhancing the transparency of reporting on the AIU's inspections of the work of the UK's audit profession.

40. In the year to 31 March 2008 the AIU conducted seven full scope inspections of large audit firms and reviewed 90 individual audits of major public interest entities. Some 25% of those audits were of entities in the banking, finance and investment industry sectors.

41. On 8 December 2008 the POB published an overview report on the AIU's inspection findings at all firms together with individual reports on its findings at seven of the largest UK audit firms. The reports conclude that the quality of auditing in the UK remains fundamentally sound with no systemic weaknesses. However, they identify some important issues in certain areas in relation to which further improvements need to be made by the audit firms. A full copy of the overview report is included as Appendix C.

42. Due to statutory confidentiality provisions it is not appropriate to attribute AIU findings to specific audit engagements. However, it is possible to report that a small proportion, around 15%, of the audits reviewed at the seven major firms were considered by the AIU to require significant improvement in certain areas. Only three of those audits related to entities which were listed on a regulated market, within the meaning of Part VI of the Financial Services and Markets Act 2000, and none related to the audit of a company within the FTSE100.

43. The AIU undertook an assessment during 2007/8 of how the seven major firms were responding at a firm-wide level to the audit challenges arising from the "credit crunch". The public reports on individual firms contain a brief commentary on how each firm responded. Overall, the AIU considered that the firms responded appropriately and on a timely basis to the significant challenges arising. However, the AIU's assessment of these responses was, in most cases, made prior to 31 December 2007 in order to assess their likely impact on audits relating to this major reporting date. It therefore did not address audit challenges associated with the more recent turmoil in the financial markets or how the firms responded at an individual audit engagement level. This will be considered and reported on in due course.

44. The AIU has made a number of changes for its 2008/9 inspection cycle to respond to the heightened audit risk posed by the credit market turbulence. It had earlier met with each of the largest firms to discuss how they were responding to the heightened risk both at a firm-wide level and in planning and executing individual audits. These changes included:

- Adopting a more risk-based approach in selecting individual audits for reviews and prioritising reviews within the 2008/9 cycle.

- Reviewing and updating the work programmes used for reviews of individual audits to ensure that risk areas relating to the credit market turbulence were covered in all cases.
- Undertaking some reviews focused specifically on issues relating to the credit market turbulence.

45. The 2008/9 inspection cycle has not yet been completed and therefore it is not yet possible to report the findings from this work. However, the POB does not believe that there are any major systemic issues emerging from the AIU's 2008/9 inspection cycle to undermine its view that the quality of auditing in the UK remains fundamentally sound.

46. As part of its annual planning cycle the AIU is actively considering, in conjunction with the POB, the need for further changes to its inspection focus and methodology for 2009/10 in order to respond appropriately to the audit risks arising from more recent developments in financial markets.

### **Going concern in the current economic conditions**

47. International Accounting Standard (IAS) 1 (Presentation of financial statements) and UK Financial Reporting Standard (FRS) 18 (Accounting policies) require management/directors to make an assessment of an entity's ability to continue as a going concern when preparing financial statements. IAS 1.25 states: "When preparing financial statements, management shall make an assessment of an entity's ability to continue as a going concern. An entity shall prepare financial statements on a going concern basis unless management either intends to liquidate the entity or to cease trading, or has no realistic alternative but to do so. When management is aware, in making its assessment, of material uncertainties related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern, the entity shall disclose those uncertainties."

48. In November 2008, recognising the challenge of current economic conditions, the FRC published guidance on going concern and liquidity disclosures. The publication brings together existing guidance in the context of recent developments relating to going concern and liquidity risk disclosures to assist directors, audit committees and finance teams of listed companies during the forthcoming reporting season. It does not establish any new requirements but it does highlight the importance of clear disclosure about going concern and liquidity risk in current economic conditions. It may also be useful for directors of unlisted companies who have similar responsibilities to assess going concern and make appropriate disclosures.

49. The difficult economic conditions being faced by many companies necessitates careful consideration by directors when assessing whether it is reasonable for them to use the going concern basis of accounting, and whether adequate disclosure has been given of going concern risks and other

uncertainties. Addressing these challenges well before the preparation of annual reports and accounts may help avoid a last minute problem that might unsettle investors and lenders unnecessarily. However, the reduced availability of credit from banks in the current economic conditions makes it more difficult for directors and auditors to satisfy themselves on the use of the going concern basis of accounting.

50. Current economic conditions necessitate careful consideration of going concern also by auditors and, to assist, the APB issued guidance specifically for auditors in December 2008.

51. If auditors conclude that the disclosures regarding going concern are not adequate to meet the requirements of accounting standards, including the need for the financial statements to show a true and fair view, they are required to express a qualified or adverse opinion as appropriate. The auditors report is also required to include specific reference to the fact that there is a material uncertainty that may cast significant doubt about an entity's ability to continue as a going concern.

52. If the auditor concluded that a material uncertainty exists that leads to significant doubt about the ability of the entity to continue as a going concern, and those uncertainties have been adequately disclosed in the financial statements, it is required to modify its report by including an emphasis of matter paragraph. However, the general economic situation at the present time does not, of itself, necessarily mean that a material uncertainty exists about an entity's ability to continue as a going concern or justify auditors modifying their reports.

### **The importance of corporate governance, including audit committees**

53 The Combined Code on Corporate Governance sets out the standards of good practice in relation to such issues as board composition and development, remuneration, accountability and audit and relations with shareholders.

54. The Combined Code was first issued in 1998 and has been updated on a regular basis since. The Code incorporates certain key associated guidance; the Turnbull guidance which provides guidance to companies on how to apply the section of the code dealing with internal control and the FRC Guidance on Audit Committees (formerly known as the Smith Guidance).

55 If a company chooses not to comply with one or more provisions of the Code, it must give shareholders a careful and clear explanation which shareholders should evaluate on its merits. In providing an explanation, the company should aim to illustrate how its actual practices are consistent with the principle to which the particular provision relates and contribute to good governance.

56. As a result the Code is not a rigid set of rules. Rather, it is a guide to the components of good board practice distilled from consultation and widespread

experience over many years. While it is expected that companies will comply wholly or substantially with its provisions, it is recognised that non-compliance may be justified in particular circumstances if good governance can be achieved by other means. A condition of non-compliance is that the reasons for it should be explained to shareholders, who may wish to discuss the position with the company and whose voting intentions may be influenced as a result. This 'comply or explain' approach has been in operation since the Code's beginnings in 1992 and the flexibility it offers is valued by company boards and by investors in pursuing better corporate governance.

57. The Turnbull Guidance on internal control was originally issued in 1999 to assist directors in applying those aspects of the code relevant to internal control and reporting to shareholders thereon. The guidance was intended to:

- reflect sound business practice whereby internal control is embedded in the business processes by which a company pursues its objectives;
- remain relevant over time in the continually evolving business environment; and
- enable each company to apply it in a manner which takes account of its particular circumstances.

58. The guidance is based on the adoption by a company's board of a risk-based approach to establishing a sound system of internal control and reviewing its effectiveness. This should be incorporated by the company within its normal management and governance processes. It should not be treated as a separate exercise undertaken to meet regulatory requirements.

59. In 2004, the Financial Reporting Council established the Turnbull Review Group to consider the impact of the guidance and the related disclosures and to determine whether the guidance needed to be updated. In reviewing the impact of the guidance, the consultations revealed that it had very successfully gone a long way to meeting its original objectives. Boards and investors alike indicated that the guidance had contributed to a marked improvement in the overall standard of risk management and internal control since 1999. Notably, the evidence gathered by the Review Group demonstrated that respondents considered that the substantial improvements in internal control instigated by application of the Turnbull guidance had been achieved without the need for detailed prescription as to how to implement the guidance.

60. The principles-based approach required boards to think seriously about control issues and enabled them to apply the principles in a way that appropriately dealt with the circumstances of their business.

61. The evidence also supported the proposition that the companies which have derived most benefit from application of the guidance were those whose boards saw embedded risk management and internal control as an integral part of running the business. Accordingly, the Review Group strongly endorsed

retention of the flexible, principles-based approach of the original guidance and made only a small number of changes.

62. The FRC Guidance on Audit Committees (formerly known as the Smith Guidance) was first published in 2003 and updated in 2005 and 2008. It is intended to assist company boards when implementing the sections of the Combined Code on Corporate Governance dealing with audit committees and to assist directors serving on audit committees in carrying out their role.

63. While all directors have a duty to act in the interests of the company the audit committee has a particular role, acting independently from the executive, to ensure that the interests of shareholders are properly protected in relation to financial reporting and internal control.

64. The guidance requires that the main role and responsibilities of the audit committee should be set out in written terms of reference and should include:

- to monitor the integrity of the financial statements of the company and any formal announcements relating to the company's financial performance, reviewing significant financial reporting judgements contained in them; to review the company's internal financial controls and, unless expressly addressed by a separate board risk committee composed of independent directors or by the board itself, the company's internal control and risk management systems;
- to review and monitor the external auditor's independence and objectivity and the effectiveness of the audit process, taking into consideration relevant UK professional and regulatory requirements;
- to make recommendations to the board, for it to put to the shareholders for their approval in general meeting, in relation to the appointment of the external auditor and to approve the remuneration and terms of engagement of the external auditor;
- to monitor and review the effectiveness of the company's internal audit function;
- to develop and implement policy on the engagement of the external auditor to supply non-audit services, taking into account relevant ethical guidance regarding the provision of non-audit services by the external audit firm; and
- to report to the board, identifying any matters in respect of which it considers that action or improvement is needed, and making recommendations as to the steps to be taken.

65. The FRC promotes high standards of corporate governance through the Combined Code, but does not monitor or enforce its implementation by individual boards. The corporate governance framework that applies to the UK listed sector as a whole places primary responsibility for monitoring the behaviour of company boards on the company's shareholders. The rationale for

this is that, as one of the main purposes of good governance is to ensure that the board acts in the long-term interests of the shareholders, the shareholders should be the ones to judge whether the arrangements the board has put in place will achieve that objective. In addition there are some aspects of corporate governance that are not easily amenable to traditional regulation as there is no evidence that any particular practice will always deliver better protection and better company performance.

66. Boards are required under the FSA Listing Rules to apply the principles of the Combined Code, of which the FRC is the author, and either to comply with its provisions or explain to the shareholders why it has chosen not to do so. For financial years ending 28 June 2009 or later companies will also be required under new FSA Corporate Governance Rules to make a number of additional disclosures in the annual report. While the FSA can take enforcement action if a company fails to comply with either set of Rules, it is left to the company's shareholders to judge whether the governance arrangements that have been put in place are adequate, and, if not, to use their influence and legal rights to resolve their concerns.

67. The effectiveness of the UK's approach to corporate governance is important because an entity's corporate governance arrangements, including in particular the role its audit committee, impact the quality of financial reporting and the effectiveness of independent audit.

*January 2009*

## **Appendix A**

### **THE FRC AND ITS OPERATING BODIES**

A1 The Financial Reporting Council (FRC) is the UK's independent regulator responsible for promoting confidence in of corporate reporting and governance. Working mainly through the Board's Committee on Corporate Governance the FRC promotes high standards of corporate governance through the Combined Code, but does not monitor or enforce its implementation by individual boards. Working through its six operating bodies, the FRC sets standards for auditing and actuarial practice and for specific aspects of financial reporting. It monitors and, where appropriate, enforces accounting and auditing standards for listed and other major public interest entities. It also oversees the regulatory activities of the professional accountancy bodies and operates independent disciplinary arrangements for public interest cases involving accountants and actuaries.

#### **Our aim**

A2 Confidence in corporate reporting and governance is a fundamental prerequisite for the effective functioning of the economy and financial markets. The FRC's aim is to strengthen that confidence by promoting high-quality corporate governance, corporate reporting, auditing and actuarial practice, and

by promoting the integrity, competence and transparency of the accountancy and actuarial professions.

### **Our regulatory philosophy**

A3 The FRC does not regard regulation as an end in itself. We believe in wealth creation. We believe that our role in promoting confidence in corporate reporting and governance as part of a regulatory framework that promotes enterprise, investment and employment can make the creation of wealth more likely. We are committed to the Better Regulation Commission principles of proportionality, targeting, consistency, transparency and accountability. We are clear that no system of regulation can eliminate the possibility of corporate reporting or governance failures; any attempt to achieve zero failure would destroy wealth rather than facilitate its creation.

### **The strategic outcomes we seek**

A4 The strategic outcomes the FRC seeks are that:

- Companies are led in a way which facilitates entrepreneurial success and the management of risk.
- Corporate reports contain information which is relevant, reliable, understandable and comparable, and are useful for decision-making, including stewardship decisions.
- Users of audit reports can place a high degree of reliance on the audit opinion, including whether financial statements show a true and fair view.
- Users of actuarial information can place a high degree of reliance on its relevance, transparency of assumptions, completeness and comprehensibility.
- Clients and employers of professionally qualified accountants and actuaries and of accountancy and actuarial firms can rely on them to act with integrity and competence, having regard to the public interest.
- The FRC is an effective and independent regulator, actively helping to shape UK, and to influence EU and global, approaches to corporate reporting and governance.

A5 We believe there are strong connections among corporate governance, auditing, actuarial practice, corporate reporting and the professionalism of accountants and actuaries. We believe the breadth of our responsibilities and functions enhances our effectiveness.

### **Our structure**

A6 The decision-making bodies are the Board of FRC Ltd and its operating body boards.

A7 The Board of FRC Ltd is designed to be composed of the Chair, the Deputy-Chair, the Chief Executive, the Chairs of the six operating bodies, and seven non-executive directors. The FRC Chair and Deputy-Chair are appointed by the Secretary of State for Business, Enterprise and Regulatory Reform. All other members are appointed by the Board.

A8 The Board's functions include:

- To determine our strategy and priorities.
- To set our budget, secure the necessary funding and monitor expenditure.
- To oversee the delivery by each operating body of its functions.
- To approve changes to the Combined Code on Corporate Governance.

A9 The Committee on Corporate Governance supports the Board of the FRC in its work on corporate governance. The Committee keeps under review developments in corporate governance generally, reflecting the FRC's objective of fostering high standards. It monitors the Combined Code on Corporate Governance and its implementation by listed companies and shareholders.

### **The operating bodies**

A10 The Accounting Standards Board issues accounting standards for the UK and Ireland but, with the move to International Financial Reporting Standards (IFRS), it is increasingly focussed on influencing the setting of standards by the International Accounting Standards Board (IASB) on behalf of its stakeholders.

A11 The Auditing Practices Board issues standards and guidance for auditing, for the work of reporting accountants in connection with investment circulars, and for auditors' integrity, objectivity and independence. It is also active in influencing the International Auditing and Assurance Standards Board in setting International Standards on Auditing.

A12 The Board for Actuarial Standards, set up in 2005 following a decision to establish independent oversight of the actuarial profession, sets technical standards for actuarial work.

A13 The Professional Oversight Board provides independent oversight of the regulation of accountants and actuaries by their respective professional bodies. It provides statutory oversight of the regulation of the auditing profession by the recognised supervisory and qualifying bodies, and, through the Audit Inspection Unit, monitors the quality of the auditing function in relation to economically significant entities.

A14 The Financial Reporting Review Panel reviews company accounts for compliance with the law and accounting standards. The Panel reviews the annual

accounts of some 300 public and large private companies a year and keeps under review interim and final reports of certain other listed issuers. It is the role of the Panel to enquire into cases where, in the words of the Companies Act, 'it appears to the Panel that there is, or may be, a question whether accounts comply with the requirements of this Act'.

A15 The Accountancy and Actuarial Discipline Board is the independent investigative and disciplinary body for accountants and actuaries in the UK. It is responsible for operating and administering independent disciplinary schemes. The Accountancy Scheme covers Members of the following accountancy professional bodies: the Association of Chartered Certified Accountants, the Chartered Institute of Management Accountants, the Chartered Institute of Public Finance and Accountancy, the Institute of Chartered Accountants in Ireland, the Institute of Chartered Accountants of Scotland and the Institute of Chartered Accountants in England and Wales. The Actuarial Scheme covers Members of the Institute of Actuaries and the Faculty of Actuaries.

## Appendix B

### THE FRC'S AUDIT QUALITY FRAMEWORK

#### One – Introduction

This Audit Quality Framework is designed to support effective communication between auditors, audit committees, preparers, investors and other stakeholders on audit quality. The Framework has been prepared following extensive consultation on the FRC's publication, Promoting Audit Quality, issued in November 2006. The Framework is intended to be complementary to existing regulations and guidelines and promotes the following key drivers of audit quality:

- The culture within an audit firm;
- The skills and personal qualities of audit partners and staff;
- The effectiveness of the audit process;
- The reliability and usefulness of audit reporting; and
- Factors outside the control of auditors affecting audit quality.

The FRC hopes that the publication of this Framework will assist:

- Companies – in evaluating audit proposals;
- Audit Committees – in undertaking annual assessments of the effectiveness of external audits;
- All stakeholders – in evaluating the policies and actions taken by audit firms to ensure that high quality audits are performed, whether in the UK or overseas; and
- Regulators – when undertaking and reporting on their monitoring of the audit profession.

Pursuant to regulations to be made by the Professional Oversight Board<sup>1</sup>, some audit firms will be required to prepare Transparency Reports. Such

Transparency Reports will be a useful opportunity for such audit firms to differentiate themselves by setting out the steps that they are taking to achieve audit quality by reference to this Audit Quality Framework.<sup>2</sup>

The FRC recognises that audit quality is a dynamic concept and that the drivers and indicators of audit quality may change over time. It will therefore periodically update this Framework in the light of comments received. The first such review will take place in autumn 2008.

The Audit Quality Framework is supported by other publications, including statements, standards, guidance and discussion papers published by the FRC and its Operating Bodies. These are available on its website at: [www.frc.org.uk](http://www.frc.org.uk).

<sup>1</sup> Directive 2006/43/EC on Statutory Audits of Annual and Consolidated Accounts came into force on 29 June 2006 and must be implemented by 29 June 2008. Regulations to be made by the POB are expected to come into force on 6 April 2008 and apply in respect of the accounts of the relevant audit firms relating to financial years starting after that date.

<sup>2</sup> It is not envisaged that the regulations for Transparency Reports will go beyond the requirements of the Statutory Audit Directive.

## Two - Audit Quality Framework

Driver	Indicators
<p>The culture within an audit firm</p>	<p>The culture of an audit firm is likely to provide a positive contribution to audit quality where the leadership of an audit firm:</p> <ul style="list-style-type: none"> <li>• Creates an environment where achieving high quality is valued, invested in and rewarded.</li> <li>• Emphasises the importance of 'doing the right thing' in the public interest and the effect of doing so on the reputation of both the firm and individual auditors.</li> <li>• Ensures partners and staff have sufficient time and resources to deal with difficult issues as they arise.</li> <li>• Ensures financial considerations do not drive actions and decisions having a negative effect on audit quality.</li> <li>• Promotes the merits of consultation on difficult issues and supporting partners in the exercise of their personal judgement.</li> <li>• Ensures robust systems for client acceptance and continuation.</li> <li>• Fosters appraisal and reward systems for partners and staff that promote the personal characteristics essential to quality auditing.</li> <li>• Ensures audit quality is monitored within firms and across international networks and appropriate consequential action is taken.</li> </ul>

Driver	Indicators
<p>The skills and personal qualities of audit partners and staff</p>	<p>The skills and personal qualities of audit partners and staff are likely to make a positive contribution to audit quality where:</p> <ul style="list-style-type: none"> <li>• Partners and staff understand their clients' business and adhere to the principles underlying auditing and ethical standards.</li> <li>• Partners and staff exhibit professional scepticism in their work and are robust in dealing with issues identified during the audit.</li> <li>• Staff performing detailed 'on-site' audit work have sufficient experience and are appropriately supervised by partners and managers.</li> <li>• Partners and managers provide junior staff with appropriate 'mentoring' and 'on the job' training.</li> <li>• Sufficient training is given to audit personnel in audit, accounting and industry specialist issues.</li> </ul>

Driver	Indicators
The effectiveness of the audit process	<p>An audit process is likely to provide a positive contribution to audit quality where:</p> <ul style="list-style-type: none"> <li>• The audit methodology and tools applied to the audit are well structured and: <ul style="list-style-type: none"> <li>○ Encourage partners and managers to be actively involved in audit planning.</li> <li>○ Provide a framework and procedures to obtain sufficient appropriate audit evidence effectively and efficiently.</li> <li>○ Require appropriate audit documentation.</li> <li>○ Provide for compliance with auditing standards without inhibiting the exercise of judgement.</li> <li>○ Ensure there is effective review of audit work.</li> <li>○ Audit quality control procedures are effective, understood and applied.</li> </ul> </li> <li>• High quality technical support is available when the audit team requires it or encounters a situation it is not familiar with.</li> <li>• The objectives of ethical standards are achieved, providing confidence in the integrity, objectivity and independence of the auditor.</li> <li>• The collection of sufficient audit evidence is not inappropriately constrained by financial pressures.</li> </ul>

Driver	Indicators
The reliability and usefulness of audit reporting	<p>Audit reporting is likely to provide a positive contribution to audit quality where:</p> <ul style="list-style-type: none"> <li>• Audit reports are written in a manner that conveys clearly and unambiguously the auditor’s opinion on the financial statements and that addresses the needs of users of financial statements in the context of applicable law and regulations.</li> <li>• Auditors properly conclude as to the truth and fairness of the financial statements.</li> <li>• Communications with the audit committee include discussions about: <ul style="list-style-type: none"> <li>○ The scope of the audit.</li> <li>○ The threats to auditor objectivity.</li> <li>○ The key risks identified and judgements made in reaching the audit opinion.</li> <li>○ The qualitative aspects of the entity’s accounting and reporting and potential ways of improving financial reporting.</li> </ul> </li> </ul>

Driver	Indicators
Factors outside the control of auditors	<p>Factors outside the control of auditors which are likely to make a positive contribution to audit quality include:</p> <ul style="list-style-type: none"> <li>• An approach to corporate governance within the reporting entity that attaches importance to corporate and financial reporting and to the audit process.</li> <li>• Audit committees that are active, professional and robust in dealing with issues identified during the audit.</li> <li>• Shareholders that support auditors, where appropriate, thereby increasing the likelihood that directors and management will comply with their obligations in relation to the preparation of reliable financial statements.</li> <li>• Reporting deadlines that allow the opportunity to carry out an audit without undue reliance on work performed before the end of the reporting period.</li> <li>• Appropriate agreed arrangements for any limitation of liability.</li> <li>• An audit regulatory environment that focuses on the drivers of audit quality.</li> </ul>

## Appendix C

### **Audit Inspection Unit 2007/8 Audit Quality Monitoring An Overview**

#### One – Introduction

The Professional Oversight Board, part of the Financial Reporting Council, has today published reports on the Audit Inspection Unit's (AIU) inspections for 2007/8 of the following seven audit firms:

BDO Stoy Hayward LLP,  
Deloitte & Touche LLP,  
Ernst & Young LLP,  
Grant Thornton UK LLP,  
KPMG LLP and KPMG Audit Plc,  
PKF (UK) LLP, and  
PricewaterhouseCoopers LLP.

The reports cover reviews of firm-wide procedures and individual audits undertaken by the AIU in the period from April 2007 to March 2008. The individual audits reviewed related to financial years ending between June 2006 and August 2007.

This is the first occasion that AIU reports on the findings of inspections of individual audit firms have been made publicly available and is part of our programme to support the continuous improvement of audit quality. The reports are available from the FRC's website:

<http://www.frc.org.uk/pob/audit/firmreports.cfm>.

The term "major firms" is used to refer to those firms which audit more than ten entities within the AIU's scope, as determined each year by the Oversight Board, and are therefore subject to full scope AIU inspections. There are currently nine such firms, comprising the seven firms noted above, Baker Tilly UK Audit LLP and Horwath Clark Whitehill LLP. The AIU will undertake inspections of the latter two firms (which were not visited in 2007/8) during 2008/9 and reports on its findings will be published during 2009.

Firms that audit up to ten entities falling within the AIU's scope are referred to as "smaller firms".

An overview of key findings arising from the AIU's inspection work in 2007/8 at both the seven major firms noted above and at smaller firms is set out in Section Two.

The scope of and background to the AIU's work, including details on the coverage of its 2007/8 inspections, is outlined in Section Three.

A summary of the findings from the AIU's 2007/8 inspections at smaller firms, which are not subject to separate public reporting, is set out in the Appendix.

## **Two - AIU Inspections 2007/8: Key findings**

### **2.1 Introduction**

This Section provides an overview of key findings arising from the AIU's inspection work in 2007/8 at both the seven major firms for which individual public reports have been published ("the seven major firms") and at smaller firms.

### **2.2 Overview of findings**

The AIU considers the quality of auditing in the UK to be fundamentally sound. The AIU public reports indicate that the senior management of the seven major firms are committed to audit quality and have quality control procedures in place which are appropriate to their size and the nature of their client base. The reports confirm that in each case the AIU has recommended to the relevant Audit Registration Committee that the firm's registration to conduct audit work be continued. The AIU believes that its inspection process is both rigorous and challenging for firms and that the progress achieved by the firms in addressing the findings from its inspections in previous years has contributed significantly to an improvement in the overall quality of audit work in the UK.

In relation to its reviews of individual audits undertaken by the seven major firms, the AIU considered the audit work generally to have been performed to a good or acceptable standard. However, the AIU's review of individual audits at each firm identified certain areas in relation to which further improvements need to be made by the firms.

A small proportion of the audits reviewed at the seven major firms were considered by the AIU to require significant improvement in certain areas. Only three of these audits related to entities which were listed on a regulated market<sup>12</sup> and none related to FTSE100 entities. The proportion of audits requiring significant improvement was, however, higher at the "smaller firms".

While the AIU's public reports seek to provide useful information for interested parties, they do not provide a comprehensive basis for assessing the comparative merits of individual firms. The findings reported for each firm in any one year reflect a wide range of factors, including the number, size and complexity of the individual audits selected for review by the AIU which, in turn, reflects the firm's client base. An issue reported in relation to a particular firm might also apply to other firms. Only a small sample of audits is selected for review at each firm and the findings may therefore not be representative of the overall quality of each firm's audit work.

Key findings arising from its inspection work in 2007/8 that the AIU wishes to highlight are set out below. The AIU referred in last year's public report to its

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<sup>12</sup> Within the meaning of Part VI of the Financial Services and Markets Act 2000.

principles-based approach to improving audit quality and the importance it attaches to firms observing the principles underlying Auditing Standards and Ethical Standards as well as the specific requirements thereof. A number of the matters referred to below build on this theme.

#### *Audit evidence and related judgments*

A key aspect of the AIU's work is the review of significant audit judgments, including the acceptability of accounting treatments adopted, the reasonableness of assumptions used in accounting estimates and judgments relating to the nature and extent of the audit work performed and the adequacy of the audit evidence obtained. While the AIU was generally satisfied with the basis on which significant audit judgments were made, the public reports all comment specifically on issues arising in this area. The areas in which issues arose included the appropriateness of audit judgments relating to valuations, impairment and provisioning; the basis on which reliance was placed by the auditors on the work of third parties; and the adequacy of the audit evidence obtained in relation to material stock balances.

The AIU continues to believe that the thought processes underlying significant audit judgments need to be properly evidenced at the time and that failure to do so increases the risk of them being incomplete or misguided and of inappropriate audit judgments being made as a result. Firms need to continue their efforts to achieve improvements in this key area which, in the AIU's view, is central to the principles-based approach to auditing in the UK.

#### *Risk assessment*

Auditing Standards require the identification and assessment of the risks of the financial statements being materially misstated, including those risks which require special audit consideration (such risks are termed "significant risks"). A proper assessment of the significance of identified risks is important to ensure that audit work planned and undertaken is sufficiently focused on higher risk areas of the audit.

The AIU raised issues relating to the identification of significant risks at most firms, concerning either the appropriateness of the firm's guidance or the application of that guidance on individual audits. The AIU also raised issues at a number of firms relating to the evaluation of the design and implementation of related internal controls.

While the AIU noted that improvements had been achieved in this area at a number of firms, it considers that there is scope for further improvement at all firms to ensure that the requirements of Auditing Standards relating to risk assessment procedures are fully complied with.

#### *Analytical review*

The AIU continues to identify weaknesses at most firms in the use of analytical procedures to obtain audit evidence. In the majority of cases the issues identified by the AIU related to a failure to set appropriate expectations and/or thresholds for investigation of variances from those expectations, together with insufficient corroboration by the audit teams of explanations obtained. In a number of audits, the AIU concluded that there were significant weaknesses in analytical procedures performed to obtain audit evidence.

The AIU notes that most firms have appropriate guidance on how to undertake analytical review procedures and that this has been recently enhanced at some firms. The issue primarily relates to the application of the firms' procedures and supporting guidance in practice. The AIU considers this to be an area where continued efforts to achieve improvements are required.

#### *Reporting to those charged with governance*

Appropriate communication with audit committees or other relevant governance bodies contributes to the quality of an audit and assists both parties in discharging their responsibilities effectively. Generally the AIU considered the quality of reporting to audit committees by firms to be of a good standard. However, the AIU has observed that where the corporate governance arrangements, particularly the role of the audit committee, is less formalised this can adversely impact on the quality of communications with those charged with governance.

#### *Audit challenges arising from the "credit crunch"*

The AIU undertook an assessment during 2007/8 of how the seven major firms were responding at a firm-wide level to the audit challenges arising from the "credit crunch". The public reports contain a brief commentary on how each firm responded. Overall the AIU considered that the firms responded appropriately and on a timely basis to the significant challenges arising. However, the AIU's assessment of these responses was, in most cases, made prior to 31 December 2007 in order to assess their likely impact on audits relating to this major reporting date. It therefore did not address audit challenges associated with the more recent turmoil in the financial markets or how the firms responded at an individual audit engagement level.

#### *Ethical Standards*

While the AIU identified very few clear breaches of the specific requirements of the Ethical Standards at the seven major firms, it identified certain areas where the underlying principles of the Ethical Standards were, in its view, not being fully observed by some of the firms. A number of examples are set out below.

The number of issues relating to independence requirements under the Ethical Standards which the AIU identified at smaller firms was higher. The AIU partly attributes this to a lack of familiarity on the part of some smaller firms with the additional requirements under the Ethical Standards for listed entities.

Independence issues identified by the AIU at smaller firms included long association with the audit client, involvement in the preparation of the client's financial statements and fee dependency. Further details are provided in the Appendix.

#### *Long association with audit clients*

Firms are required to have policies and procedures in place to monitor the length of service of partners and senior staff on individual audit engagements, assess any threats arising to auditor objectivity and implement appropriate safeguards. This reflects the need to avoid auditor independence being compromised by the familiarity threat arising from a long period of service in a senior role. For listed company audits, the audit engagement partner is required to rotate after having served for a maximum period of five years and "key audit partners"<sup>13</sup> (KAPs) are required to rotate after seven years.

The AIU has previously commented on the adequacy of firms' systems for monitoring compliance with the specific rotation requirements for audit engagement partners and KAPs. While the AIU considers that there is still work to be done in some cases to improve the completeness and integrity of rotation databases, the AIU was generally satisfied with the progress the firms have made in this area.

The AIU noted that there has generally been an increase in the number of partners identified as KAPs, although there is some variation in practice between the firms particularly in relation to specialist partners involved in major listed group audits. The change in the definition of a KAP (now referred to as a "key partner involved in the audit"<sup>14</sup>) under the revised Ethical Standards issued in April 2008 should, in the AIU's view, provide firms with a catalyst to review their identification of KAPs on major listed group audits.

The AIU has previously commented on the issue of long involvement on large group audits by the audit engagement partner. Such long involvement, which will have been in varying capacities and often continuous, may not be precluded by the Ethical Standards but nonetheless gives rise to familiarity threats. In the AIU's view, firms continue to give insufficient consideration to the independence threats arising and, as a consequence, have often not applied appropriate additional safeguards to mitigate them. While the AIU believes that the new definition of a "key partner involved in the audit" under the revised Ethical Standards should help to address this issue, it considers that firms nevertheless need to look beyond the specific requirements under the Ethical Standards and

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<sup>13</sup> Partners other than the audit engagement partner who are responsible for key audit decisions or judgments.

<sup>14</sup> The definition has been extended to include partners who are responsible for the audit of material subsidiaries, in accordance with the requirements of the EU Statutory Audit Directive (Directive 2006/43/EC), and to make it clear that it covers non-audit professionals such as tax partners who are responsible for key audit decisions or judgments.

to take a more principles-based approach in assessing the threats arising from such long involvement.

*Rewarding KAPs for selling non-audit services to audit clients*

The AIU identified that some firms permit senior specialist personnel from outside the audit function who are involved in audits, including those identified as KAPs on those audits, to be rewarded for selling non-audit services or for their performance to be evaluated based on their success in selling non-audit services.

While the Ethical Standards do not explicitly address this issue, in the AIU's view the underlying principles of the Standards indicate that such KAPs should be treated in the same way as other audit partners responsible for key audit decisions or judgments and that they should not be rewarded for selling non-audit services to the audit clients concerned.

*Direct assistance from internal audit staff*

The AIU identified that some firms have policies and practices which permit the use of staff from a client's internal audit department to perform external audit procedures directly for the audit team.

While Standards permit firms to place appropriate reliance on the work of clients' internal audit functions, they do not specifically address the use of internal audit staff to provide direct assistance to the external auditors in this way.

In the AIU's view, the practice of including staff from clients' internal audit departments in external audit teams may be inconsistent with the underlying principles of the Ethical Standards because it is not possible for such staff to be independent of their employers. The AIU considers that firms should review the appropriateness of this practice and what safeguards should be applied to address the threats to their independence arising.

## Three - Scope and background

### 3.1 Background

The overall aim of the FRC is to promote confidence in corporate reporting and governance. One of the strategic outcomes contributing to this aim is that the users of audit reports can place a high degree of reliance on the audit opinion, including whether financial statements show a true and fair view. The AIU's programme of inspections visits is designed to promote high quality auditing and thereby contribute to this strategic outcome.

The AIU's inspections of the major audit firms, on which it reports publicly, comprise a review of the firms' policies and procedures supporting audit quality and a review of the quality of selected audits of listed and other major public interest entities that fall within the scope of independent inspection, as determined each year by the Oversight Board.

The AIU reviews firms' policies and procedures in the following areas:

- Leadership, strategy and communications
- Performance evaluation, promotions and remuneration
- Other human resource matters
- Client risk assessment and acceptance/continuance
- Consultation and review
- Audit quality monitoring
- Independence and ethics
- Audit methodology

The AIU's reviews of individual audits place emphasis on the appropriateness of significant audit judgments exercised in reaching the audit opinion, as well as the sufficiency and appropriateness of the audit evidence obtained.

The AIU's inspections include, but are not restricted to, an assessment of compliance with the requirements of relevant standards and other aspects of the regulatory framework for auditing. These comprise the auditing standards and ethical and quality control standards for auditors issued by the FRC's Auditing Practices Board (APB)<sup>15</sup> and other relevant requirements under the Audit Regulations<sup>16</sup>. The standards referred to in the AIU's reports for 2007/8 are those effective at the time of the AIU's inspection or, in relation to its review of individual audits, those effective at the time the relevant audit was undertaken. (The APB issued revised Ethical Standards in April 2008 which are effective for audits of financial statements for periods commencing on or after 6 April 2008.)

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<sup>15</sup> International Standards on Auditing (UK and Ireland), APB Ethical Standards and International Standard on Quality Control (UK and Ireland) 1.

<sup>16</sup> The Audit Regulations are issued jointly by The Institute of Chartered Accountants in England and Wales, The Institute of Chartered Accountants of Scotland and the Institute of Chartered Accountants in Ireland.

The AIU seeks to identify areas in which improvements are, in its view, required to safeguard audit quality, including matters relating to compliance with regulatory requirements, and to agree an action plan with the firm designed to achieve these improvements. The AIU also assesses the extent to which the firm has addressed the findings and recommendations arising from its last AIU inspection.

The AIU provides the Audit Registration Committee of the relevant professional accountancy body in the UK, who register firms to conduct audit work, with a report on each major firm containing a number of findings in relation to how the firm can improve audit quality, together with an overall recommendation on whether the firm's audit registration should be continued. These reports provide the basis for the AIU's public report on each firm. In addition, the AIU reports separately to the Audit Registration Committees on its findings from reviews of audits at smaller firms.

The AIU's inspections are not designed to, nor would it be possible to, identify all weaknesses which may exist in the design and/or implementation of the firm's policies and procedures supporting audit quality or in relation to the performance of the individual audit engagements selected by the AIU for review and cannot be relied upon for this purpose.

The AIU does not carry out a detailed technical review of the audited financial statements in reviewing individual audits. The AIU's focus in relation to financial reporting issues is on the appropriateness of audit judgments exercised and any underlying deficiencies in the firm's audit work and quality control procedures. Accounting and disclosure issues identified are therefore raised with firms in an audit context rather than a financial reporting context. Audit judgments on financial reporting issues are, however, challenged by the AIU, where appropriate, as an integral part of its work.

If the AIU identifies a significant concern during the course of a review of an individual audit as to whether an accounting treatment adopted and/or disclosures provided comply with the applicable accounting framework, it may draw the matter to the attention of the FRC's Financial Reporting Review Panel ("FRRP"). Such matters are then considered in accordance with the FRRP's Operating Procedures.

In 2007/8 the AIU drew the FRRP's attention to matters arising in relation to the financial statements of three entities whose audits it had reviewed.

Similarly, if during the course of its inspections the AIU identifies a significant concern as to the conduct of an individual or firm it may draw the matter to the attention of the FRC's Accountancy and Actuarial Discipline Board ("AADB"). In 2007/8 the AIU drew no such matters to the attention of the AADB.

The monitoring units of the professional accountancy bodies in the UK are responsible for monitoring the quality of audit engagements falling outside the scope of independent inspection by the AIU but within the scope of audit regulation in the UK. Their work, which is overseen by the Oversight Board,

covers audits of UK incorporated companies and certain other entities which do not have any securities listed on the main market of the London Stock Exchange and whose financial condition is not otherwise considered to be of major public interest.

### 3.2 Coverage of Inspections

During 2007/8, the AIU undertook full scope inspection visits, comprising a review of firm-wide procedures and individual audits within its scope, at the seven major firms noted in Section 1.1. These firms are all registered to conduct audit work by the Institute of Chartered Accountants in England and Wales. Full scope inspections of Baker Tilly UK Audit LLP and Horwath Clark Whitehill LLP, which were not visited in 2007/8, will form part of the AIU's inspection programme for 2008/9.

The AIU also carried out inspection visits at nine smaller firms. For these firms, the AIU's work comprised reviews of one or more of the small number of listed or other major public interest entities audited by them.

Staff from the US Public Company Accounting Oversight Board participated in certain aspects of the AIU's 2007/8 inspections of PricewaterhouseCoopers LLP and Deloitte & Touche LLP, by agreement with the firms concerned. All matters raised in the AIU's public reports, however, are based solely on work carried out by the AIU.

At the request of the Audit Commission, the AIU also undertook an inspection visit comprising a review of its firm-wide procedures and five individual audits. This inspection visit was undertaken on a contractual basis as entities audited by the Audit Commission are outside the scope of audit regulation. The Audit Commission has provided a high level summary of the review findings in its Audit Practice Annual Quality Report.

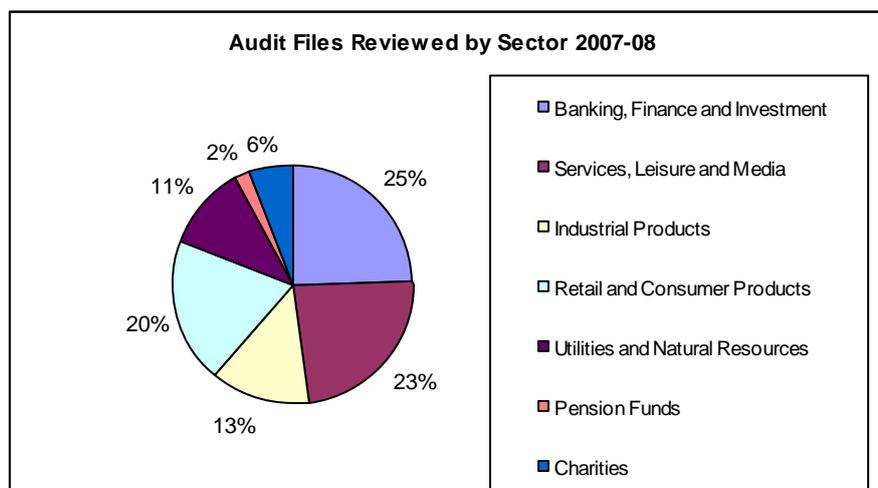
### 3.3 Analysis of audits reviewed by the AIU

In the year to 31 March 2008 the AIU completed the review of 90 audits undertaken by audit firms (compared with 103 in 2006/7)<sup>17</sup> as set out by firm type in the following table.

Firm type		File reviews 2007/8	File reviews 2006/7
Major firms {	Big four firms	60	67
	Other major firms	20	25
	Smaller firms	10	11
	<b>Total</b>	<b>90</b>	<b>103</b>

<sup>17</sup> Includes three file reviews commenced in 2006/7 and completed in 2007/8. The equivalent figure for 2006/7 was 11.

An analysis by sector of the audits reviewed by the AIU in 2007/8 is set out below:



### 3.4 Reporting

The Oversight Board consulted on changes to the reporting arrangements for the AIU in June 2007 ("Reporting on Audit Quality Monitoring-Implementing a New Approach"). The results of that consultation and the Board's policy conclusions were published on 5 December 2007.

A key change to the reporting arrangements was that the AIU would no longer publish one annual report on generic themes and findings but rather high level public reports on individual audit firms. Such reports would only be published for those firms where the AIU had undertaken a full scope inspection. The content of these reports would be based on the findings set out in the AIU's more detailed private reports to the respective audit registration committees. This change took effect for the 2007/8 inspection cycle and marks an important development in increasing the transparency of the AIU's work.

Another significant change was the introduction of new reports on individual audits reviewed by the AIU for those reviews which commenced after 1 January 2008. While these reports are addressed to the relevant audit engagement partner, the Oversight Board's expectation is that they will be provided by the firms to the relevant client's audit committee. This is a further important contribution to enhancing the transparency of reporting on the AIU's inspections of the work of the UK's audit profession.

## **Appendix – Inspections at smaller firms**

### **1 Background**

This appendix provides a summary of the AIU's inspection work at smaller firms who conduct audits of listed or other major public interest entities. As at 31 March 2007 there were approximately forty such smaller firms, ranging in scale from larger national firms to smaller regional practices. The AIU's work at smaller firms was limited to a review of one or more audits.

In 2007/8 the AIU visited nine smaller firms and reviewed ten individual audits. (In 2006/7 the AIU visited seven smaller firms and reviewed eleven individual audits.)

### **2 Principal findings**

The extent of issues identified by the AIU on the audits it reviewed at smaller firms was generally greater than at the larger firms. This may partly reflect the fact that eight of the smaller firms visited in 2007/8 had not previously been subject to an AIU inspection.

In particular, the incidence of independence issues arising was greater at smaller firms. The AIU partly attributes this to a lack of familiarity on the part of some smaller firms with the additional independence requirements for audits of listed entities, given the limited number of listed entities audited by such firms.

In the AIU's view, the majority of the ten audits it reviewed at smaller firms required significant improvements in certain areas. The sufficiency of audit evidence and compliance with independence requirements were the main areas where improvements were required.

The principal findings arising from the AIU's inspection work at smaller firms are set out below. The issues commented on below are either considered to be individually significant or are common to a number of firms.

#### **2.1 Independence issues**

Independence issues identified by the AIU at smaller firms fall into three main categories: long association with the audit client, assistance with the preparation of the client's financial statements and fee dependency. Further details are set out below.

##### *Long association with audit clients*

On two audits of listed entities, the AIU identified that the requirements of the Ethical Standards in relation to the rotation of the audit engagement partner were not being properly complied with. On one of those audits, the AIU also identified that the manager had been involved for 17 years and that there was no

evidence that the firm had considered whether appropriate safeguards were in place, as required by the Standards.

On an audit of a significant unlisted entity, the AIU identified that the audit engagement partner, the firm's chairman, had acted for this client (the firm's largest) for in excess of ten years. In such situations the AIU expects firms to ensure that the safeguards in place are strengthened over time in line with the increasing threats to independence and ultimately that firms should have a succession plan in place.

#### *Assistance with preparation of financial statements*

The AIU identified one audit of a listed group where the firm had provided assistance with the preparation of the statutory accounts of all the subsidiaries. The AIU considered that the assistance provided was not permitted under the Ethical Standards for listed entities.

#### *Fee dependency*

In relation to a significant charity audit, the AIU noted that fees earned from that client and related entities exceeded 10 percent of the firm's total fee income. In such situations the Ethical Standards require the firm to arrange for an external independent quality control review of the audit to be carried out. The AIU noted that while the firm had an external reviewer in place, the individual concerned had acted in this role for in excess of eleven years. The AIU considered, in light of this, that the firm needed to refresh the external review role. More generally the AIU considers that in situations of this nature firms need to consider and observe the principles underlying the Ethical Standards as well as the specific requirements thereof.

## **2.2 Adequacy of audit evidence**

In a number of instances, the AIU was unable to conclude that sufficient audit evidence had been obtained to support certain account balances and audit judgments. These included the adequacy of work undertaken on the profit and loss account and the sufficiency of the testing of controls where the audit approach placed reliance on their operating effectiveness.

The AIU will be undertaking follow-up reviews of the following year's audits in two cases where it had concerns as to the sufficiency of the audit evidence obtained to support material account balances.

## **2.3 Reporting to those charged with governance**

On most of the audits reviewed, the AIU identified instances where the reporting to those charged with governance did not meet all the requirements of Auditing Standards. Shortcomings identified included the failure to communicate a firm's independence in writing and insufficient communication of audit planning and audit findings. In some cases, there was a lack of clarity over to whom the

communications should be made, with communications being made for example to an individual rather than the audit committee or the directors as a whole.

#### **2.4 Audit risk and fraud standards**

On most audits reviewed the AIU identified a number of deficiencies in the evidence on file to demonstrate that the requirements of the audit risk and fraud standards had been adequately addressed. Common issues included an inadequate assessment of the risks of material misstatement at the assertion level, a lack of clarity over the identification of significant risks, insufficient consideration of fraud risks and a failure to evaluate the design and implementation of controls over significant risks. Compliance with the requirements of the audit risk and fraud standards continues to be challenging for smaller firms.

#### **2.5 Audit report**

On four audits the AIU identified that the audit report was dated before all necessary work had been completed. In each case a number of amendments were made to the annual report after the audit report date, in some cases several weeks after that date.

## **Memorandum from The Paragon Group of Companies PLC**

### **Summary**

1. The Paragon Group of Companies PLC welcomes the opportunity to respond to the Treasury Select Committee's current inquiry into the banking crisis. Our comments are focused on the importance of securitisation to the UK's mortgage market and the need for urgent action from Government to support issuance of Residential Mortgage Backed Securities (RMBS) in order to increase the supply of much needed mortgage finance.

2. Paragon is the UK's leading specialist provider of residential mortgages to professional and investor landlords. We launched our first specifically targeted mortgages in 1995 and over the last thirteen years have increasingly specialised in this market. The company currently has around 40,000 landlord customers, services 90,000 individual accounts and has around £10 billion of assets under management. One in ten residential investment property mortgages in the UK have been provided by Paragon.

3. Until wholesale markets closed in summer 2007, Paragon's principal source of long-term funding for originated assets was through securitisation. The company remains the UK's most active RMBS issuer and has a great deal of practical experience and expertise in this area; we were the first UK company to undertake an RMBS issue in 1987 and have in total issued some £19.5 billion of notes through 53 public securitisation transactions, utilising a variety of structures and currencies.

4. The key points of our submission are:

- Securitisation has played a key role in the development of a competitive and innovative mortgage market in the UK over the last decade. It has provided a cost-effective source of capital for lenders and enabled increased diversification and financial innovation.
- In the year prior to the credit crunch, securitisation accounted for the vast majority (80%) of the UK mortgage industry's net funding needs. It is a funding model that has been used widely by the major banks as well as specialist lenders.
- Use of securitisation is not restricted to the funding of consumer finance businesses. It has provided a mechanism for funding across a wide range of industry sectors, including finance for public sector projects under the PFI initiative.
- Securitisation is not an inherently risky funding model. Securitisation transactions in the UK have consistently performed within the expected parameters agreed by the various parties involved at the outset. More

fundamental problems in the US housing and mortgage market have contaminated the global wholesale funding process.

- Some of the liquidity issues affecting UK banks have centred on the mismatch of borrowing short and lending longer-term. By using securitisation, however, Paragon has been able to perfectly match its funding needs, thereby eliminating liquidity risks. Securitisation has been misunderstood and, as can be seen by this aspect, risk is reduced rather than increased.
- The unprecedented shortage in the supply of mortgage finance brought about by the closure of wholesale markets is having very negative consequences across the UK economy, restricting competition in the mortgage market and exacerbating falling demand in the housing market.
- Alternative sources of mortgage finance will not be anywhere near sufficient to revive UK mortgage lending; savings inflows alone cannot be relied upon to revive mortgage lending, particularly with interest rates at historically low levels. Reinvigorating wholesale markets for mortgage finance is therefore vital.
- The recommendations of the Crosby Review of mortgage finance – in particular the introduction of a new guarantee scheme, open to specialist lenders as well as banks, to promote issuance of RMBS – represent the single most important package of proposals to help rejuvenate the mortgage finance market.
- The future health of the UK housing market requires action from Government along the lines proposed by the Crosby Review as soon as possible, and certainly before Budget 2009. Furthermore, it is essential that non-bank specialist lenders such as Paragon are given a proper opportunity to share our extensive experience and feed our views into the development of the Government's response to Crosby.

### **Importance of securitisation**

5. In the decade prior to the emergence of problems in the US sub-prime mortgage market and the subsequent onset of the global credit crunch, a competitive and innovative mortgage market had developed in the UK, offering a wide choice of products to both existing homeowners and first time buyers. Securitisation played a very important – although often understated and misunderstood – role in this market.

6. Securitisation involves the repackaging of a ring-fenced group of assets such as residential mortgage loans, or other cash flow generating-assets including credit cards or consumer loans, into tradable securities. It is a funding model that has been used to fund the lending activity of a wide range of non-bank specialist lenders and also the lending activity of many of the high street banks.

7. Paragon and other specialist lenders who have utilised the securitisation model to fund their lending activity have played a significant role in the UK mortgage market for two decades. In 2007, six of the top 30 lenders were non-banks and it is estimated that the total non-banking sector accounted for around £70bn of outstanding assets – a 10% market share. But the importance of securitisation to the UK mortgage market extends much further; in the twelve months before the credit crunch, 80% of the net funding needs of the UK mortgage industry – encompassing both mainstream and specialist residential loans – were provided by the capital markets.

8. There are many important benefits of the securitisation funding model. It provides a cost-effective source of capital for lenders and an avenue for both increased diversification and financial innovation. It imposes external risk analysis on the business written and also ongoing performance monitoring. Moreover, it provides a mechanism through which lenders can achieve long-term matched funding. Paragon has been able to match-fund its own loan portfolio to maturity, which has eliminated the refinancing risk normally associated with lenders that borrow on a short-term basis in the money markets and lend longer-term. In this way, Paragon has avoided many of the liquidity issues faced by the major UK banks.

9. More widely, securitisation has been used successfully to fund the growth of a number of industries both in the UK and internationally; it is not merely a mechanism for the funding of consumer finance businesses. Securitisation has been used in a variety of circumstances, including:

- Whole business securitisations (e.g. for water companies)
- Securitisation of lease receivables (both small and big ticket items including ships and aircraft)
- Securitisation of public house revenues;
- Finance for the construction industry;
- Securitisation of revenues from student loan portfolios;
- Securitisation of ex-service residential property by Ministry of Defence;
- Care home finance;
- Securitisation of broadcasting/royalty rights;
- Securitisation of social housing receivables; and
- Finance for public projects under the Government's Private Finance Initiative (e.g. roads, schools and hospitals)

10. The financing of such endeavours through securitisation has proved positive for the businesses concerned and provided a successful vehicle for wider economic growth. Used properly and responsibly, securitisation is the perfect form of debt to provide long-term, committed-for-life finance.

11. With respect to the historical performance of securitisations, in the UK it is almost impossible to find a transaction that has not performed within the expected parameters agreed by the various parties at the outset, be they bankers, credit rating agencies, issuers or investors. In terms of Paragon's securitisations, despite the economic recessions and housing downturns of the

late 1980s and early 1990s, no bonds were downgraded and every investor received timely payment of interest and repayment of principal upon final redemption of the bonds.

### **Closure of wholesale funding markets**

12. The securitisation model has brought substantial benefits to the UK mortgage market by providing an essential funding basis for a variety of lenders and a key means of meeting consumers' demand. It is not an inherently risky model; more fundamental problems in the US housing and mortgage market have contaminated the global wholesale funding process, making mortgage-backed securitisations impossible to undertake at the present time. This is a major factor underlying the unprecedented shortage in the supply of mortgage finance being experienced in the UK.

13. In the years prior to the credit crunch, the regulatory regime which applied to the US mortgage market employed a much lighter touch than in the UK, and the US tax regime encouraged home ownership and stoked lending. At the same time, a property construction boom had been facilitated by more relaxed planning rules than in the UK, increasing supply beyond demand and placing downward pressure on house prices.

14. The decline of credit standards, the proliferation of 'low document' sub-prime lending and high loan-to-values, and the widespread introduction of teaser rates considerably lower than "revert to" rates had the effect of building a payment shock into the US market and exposing it to significant risk in the event that US house prices did not continue to rise. Furthermore, a small number of credit score systems (e.g. FICO) dominated across a range of markets in the US and there is evidence that investors became too reliant on these scorings and did not properly understand the risks of the underlying assets in which they were investing.

15. In the UK, the mortgage market has been much more closely regulated, planning restrictions are much tighter and housing demand has tended to outstrip supply, particularly over the last 20 years. Furthermore, while credit scoring is widely used, it has not become generalised to the same degree as is the case in the US. Nonetheless, the cycle of defaults that has taken place in the US mortgage market, caused by the downturn in its housing market and lenders' tendency not to pursue borrowers for recovery, has had a detrimental impact on UK lenders' ability to access funding through securitisation: investors' fears about mortgage performance in the US have contaminated their view of investment in mortgage assets originated in other countries.

16. It is essential to understand that in addition to different standards of lending between the US and UK there has also been a considerable difference in the way deals were structured. Arrangements such as structured investment vehicles (SIVs), collateralised loan obligations (CLOs) and collateralised debt obligations (CDOs) brought new technology to the capital markets and heightened risk. However, many of the deals, including Paragon's, were simple,

straightforward and traditional securitisations that, as previously stated, actually reduce risk. It is important that these differences are clearly understood and appreciated, and that the benefits of traditional securitisation deals are not lost due to the problems of certain high-risk structures. Clear differentiation needs to be made in this respect.

17. In addition, a misalignment in the interests of originators of the securitised assets and investors in those assets has occurred in the US where the “originate to sell” model has been widely employed. This model removes the long-term risk of the mortgages from the originators as they are sold on for securitisation. This method is not used in Europe where originators such as Paragon retain a substantial interest in their securitised mortgages, for instance, through the provision of reserve fund debt to the securitisation structure and the residual income it receives from it, and the provision of ongoing loan-servicing to the securitised mortgages.

18. The external credit rating process for securitisations is complex and opaque, and investors in the US have reportedly placed too much reliance on the end rating without fully understanding the agencies’ process or the underlying assets supporting the transaction. In addition there have been failings on the part of the credit rating agencies and investors with respect to the on-going monitoring of transaction performance.

19. Paragon has developed an award-winning sophisticated investor reporting system which is freely available on the company’s website and has been working closely with the European Securitisation Forum (ESF) in the promotion of clarity in the reporting of asset performance across the industry. Further transparency and standardisation in the assessment and monitoring of deal performance is crucial as we move forward, and by working in conjunction with the agreed principles advocated by the ESF, the industry will be better placed to provide effective self-regulation.

### **Reviving mortgage lending in the UK**

20. The unprecedented shortage in the supply of mortgage finance brought about by the closure of wholesale markets is having very negative consequences across the economy. Consumers are suffering as a result of falling competition and the limited supply of mortgage finance is exacerbating falling demand in the housing market.

21. While some commentators take the view that the fall in house prices currently taking place is essential to rebalance the housing market at more sustainable level, there is a risk that, without Government action to increase the availability of mortgage finance, the housing market will overshoot on the downside – a risk identified in Sir James Crosby’s final report on mortgage finance published by HM Treasury alongside the 2008 Pre-Budget Report.

22. Sir James has warned in his report that the current shortage of mortgage finance could cause a downward asset spiral in the UK’s housing market, with

serious consequences across all segments of the housing market and across all industries dependent on housing investment and activity. Indeed the consequences of the closure of the financial markets are already being felt in the “real economy” with a number of organisations both within and outside the housing market sector reducing staff and/or closing down completely.

23. Alternative sources of mortgage finance will not be anywhere near sufficient to revive UK mortgage lending. As noted above, the vast majority of net funding needs for mortgage finance were being met by the capital markets prior to the credit crunch. With interest rates historically low and falling and household budgets under increasing pressure, savings inflows alone cannot be relied upon to revive mortgage lending. Getting the wholesale markets for mortgage finance moving again – and soon – is absolutely critical.

24. Unfortunately, there has been a general lack of support for the non-bank lenders since the economic downturn has taken hold. This contrasts with the very significant amount of support provided by the Government and Bank of England to banks through the recapitalisation programme and special liquidity scheme. As a consequence, a large and very important part of the mortgage market has been left with no liquidity support whatsoever. Many wholesale-funded non-bank lenders, Paragon included, stand ready to re-enter the market and provide new and necessary mortgage finance but are unable to do so without assistance.

25. While we do not question the need for banks to be assisted in the current context, the lack of focus up to now on reviving lending activity in the specialist sector is very regrettable. A serious consequence of this is that the competitive landscape of the mortgage market has been altered to the detriment of specialist lenders and, ultimately, consumers.

26. The Crosby Review’s recommendations represent the single most important package of proposals to help rejuvenate the mortgage finance market. Paragon was encouraged that they include the introduction of a new guarantee scheme to promote issuance of RMBS in which non-bank specialist lenders would be eligible to participate. The details are not yet clear and there are a number of areas of concern regarding the scope and structure of the proposed scheme which will need to be addressed, but the proposed guarantee provides a potential solution to reinvigorate the mortgage finance market.

27. The commitment made by the Chancellor of the Exchequer in his Pre-Budget Statement to develop a scheme based on the Crosby Review’s recommendations was a positive step. But the commitment to bring forward proposals by Budget 2009 is simply not soon enough. We understand that there are clearly a number of complex issues that must be resolved by the Treasury in order to bring a guarantee scheme of the kind Sir James has proposed into being. However, the future health of the housing market requires an intervention of the kind envisaged in the Crosby Review very soon, and certainly before March or April 2009.

28. Getting the details of the guarantee scheme right and delivering it in short order will be critical if this intervention is to have any significant impact on the mortgage market. However, the process by which the Treasury is developing the Crosby Review recommendations into a practical mechanism remains very unclear, that pace at which its work is moving is far too slow, and the level of consultation that has been undertaken so far has been completely inadequate.

29. Paragon has a sense, correct or not, that specialist lenders such as ourselves have been kept at arms length by the Treasury as it has developed facilities to boost market liquidity in recent weeks and months. It is vital that we, and others in the specialist lending sector, are fully engaged by the Treasury and our views are given full and proper consideration as the Government develops its response to the Crosby Review – not least given the extensive expertise and market experience we are able to contribute.

### **Conclusion**

30. Urgent action from Government to help increase the provision of mortgage finance is necessary. The Crosby Review's recommendations provide a template for action, but if the industry has to wait until next spring for firm proposals based on these recommendations there is a real risk that the downward asset spiral warned of in Sir James's final report will gather pace, causing irreparable damage to the housing market and the wider economy.

31. This is something which is in the interests of consumers, Government and industry to avoid. We urge the Committee to seek assurances from Government, within the context of its inquiry, that action is being taken as quickly as possible to move the Crosby Review's proposals on mortgage finance forward and that the views of all lenders, including non-bank specialist lenders, will be sought and properly factored into the proposals that the Treasury ultimately brings forward.

January 2008

## Memorandum from News International Ltd

1. This response is made on behalf of News International Ltd, whose subsidiaries publish The Sun, The Times, News of the World, The Sunday Times, and thelondonpaper.
2. News International welcomes the opportunity to contribute to the current inquiry into the banking crisis.
3. We will confine our comments only to question (1.11) *“The role of the media in financial stability and whether financial journalists should operate under any form of reporting restrictions during banking crises.”*
4. News International does not believe that the recent banking crisis has revealed any grounds for further restrictions on financial journalism.
5. As a starting point we would refer to the comments made by Lord Bingham in *McCartan, Turkington Breen v Times Newspapers Ltd*:  
  
*“The proper functioning of a modern participatory democracy requires that the media be free, active, professional and inquiring. For this reason the courts, here and elsewhere, have recognised the cardinal importance of press freedom and the need for any restriction on that freedom to be proportionate and no more than is necessary to promote the legitimate object of the restriction.”*
6. The media plays a vital role in allowing the proper functioning of the markets by promoting, not impeding the flow of crucial information. For investors to have confidence in the market, they need to be provided with accurate information which is widely disseminated, not restricted to a limited audience. If price sensitive information is restricted, the market cannot operate efficiently.
7. Our titles together reach millions of readers a week – they are a large force for fair and well-informed markets. The journalists on our titles strive to produce accurate, insightful copy which is of use to both the financial community and, of course, to the wider public. Any failure to do this would damage the profitability of our products as readers would not wish to buy a product whose reliability and veracity was in doubt.
8. Our financial journalists have acted very responsibly during the financial crisis and, by and large, this has been the case across the industry. There has been enormous public interest in financial and business stories and our titles have taken care in the way they have reported the news, aware of the sway they can hold over people worried about their cash.

9. The system of press self-regulation has worked well. Newspapers and magazines are regulated by the Press Complaints Commission Code of Practice, which stipulates that the press must take care not to publish inaccurate, misleading or distorted information, and must distinguish clearly between comment, conjecture and fact.
10. In addition, Clause 13 of the Code deals specifically with financial journalism and states:
  - i) Even where the law does not prohibit it, journalists must not use for their own profit financial information they receive in advance of its general publication, nor should they pass such information to others.
  - ii) They must not write about shares or securities in whose performance they know that they or their close families have a significant financial interest without disclosing the interest to the editor or financial editor.
  - iii) They must not buy or sell, either directly or through nominees or agents, shares or securities about which they have written recently or about which they intend to write in the near future.
11. This Clause is backed up by a Best Practice Note disseminated by the PCC to all publishers, a copy of which is attached to our submission. *[Please see Attachment 1]*
12. There are no grounds for believing that the system of self regulation is inadequate.
13. In any case, it would be stepping into dangerous territory if reporting restrictions were introduced during a financial crisis.
14. For a start, how would a financial crisis be defined? Who would be responsible for deciding when a financial crisis starts and ends? How would you define who was a financial journalist? This might once have been fairly straightforward, but in the age of the blogosphere, social networking sites and financial chatrooms, the lines have become more blurred. Regulate the financial press more aggressively and you will simply increase the authority of comparatively unregulated sites, such as financial bulletin boards and chatrooms, which would be disastrous for the investing public.
15. Furthermore, the introduction of reporting restrictions would be wrong in principle. It is not right to attempt to regulate the financial press in the same way as the rest of the financial services sector is regulated. The financial press is not part of the financial services sector but part of the media industry and adheres to the PCC Code of Conduct as well as the usual laws on insider trading and market abuse. This system works perfectly well.

16. There is also the danger that extra reporting restrictions introduced during a financial crisis could be used by financial institutions to curtail legitimate stories for their own purposes. For example, banks might try to argue that articles exposing bad practice, such as refusing to refund unfair charges, or a failure in their cash transfer system, may be interpreted by the public as an indication that they were unable to meet their financial commitments, and should therefore not be published because they might trigger a run on the bank.
17. Another reason why reporting restrictions would be counter-productive is that the market hates uncertainty and in the absence of information will tend to assume the worst case scenario.
18. The media can operate most efficiently during financial crises if there is open access to bank executives and a level playing field.
19. The recent banking crisis has been extraordinary and, many would argue, a once in a generation event. In our view, it is crucial now to concentrate efforts on regulating the financial industry so crises do not occur, rather than looking for new ways to restrict reporting when they do.

## **Attachment 1**

### **Press Complaints Commission -- Financial Journalism Best Practice Note 2005**

#### **Introduction**

The newspaper and magazine publishing industry's Code of Practice binds all national and local newspapers, magazines and their websites. Clause 13 of the Code imposes a number of requirements relating to financial journalism, and Clause 1 (Accuracy) also has a particular relevance.

The Code:

- prohibits the use of financial information for the profit of journalists or their associates;
- imposes restrictions on journalists writing about shares in which they or their close families have a significant interest without internal disclosure;
- stops journalists dealing in shares about which they have written recently or intend to write in the near future; and
- requires that financial journalists take care not to publish inaccurate material and to distinguish between comment, conjecture and fact. This is

particularly important for any journalists making investment recommendations to readers about whether to buy, sell or hold shares.

The Code operates in the spirit as well as the letter. The intention of Clause 13 is clear: no journalist or editor should undertake any form of activity relating to financial journalism which could be open to misinterpretation or which could damage the integrity of his or her publication.

The Code was deliberately written in broad terms to ensure such high standards: the danger with precise language is that it creates loopholes. In this area of reporting, there should be none. This guidance note – drawn from the house rules of a number of different publications – is intended to supplement the provisions of the Code by laying down best practice in the industry in this area.

It also takes into consideration the Investment Recommendation (Media) Regulations 2005, which incorporate into UK law the EU Market Abuse Directive and which contain specific rules for people – including journalists – who make investment recommendations. There is an exemption in the Regulations for news reporting on recommendations made by third parties.

There is also a general exemption for investment recommendations published in media which are subject to a self-regulatory system such as that overseen by the Press Complaints Commission. This exemption is subject to two conditions which are listed at the end of this note.

If it is called upon to investigate a complaint about financial journalism, the PCC will bear in mind the terms of this note as well as the Code's provisions.

## **The terms of the Code**

*To whom does the Code apply?*

The Code applies to all journalists and their editors. The Code requires disclosure of shareholdings about which journalists are writing to editors or financial editors. Best practice on most publications requires editors to report their own interests to managing directors or publishers: this is most practically done by means of an internal register.

*What is a 'significant financial interest'?*

The Code uses this terminology – rather than specifying different types of holdings – because what might be insignificant for one person might be very significant for another. Best practice on many publications will mean the disclosure of "any" financial interest, however small. It will usually mean a direct financial interest – although there may be occasions when journalists will need to declare an indirect financial interest, such as in a unit trust, where they are writing about it in a manner which might affect its performance. However, it

might be worth noting that the Investment Recommendation Regulations define a 'significant financial interest' as including a "holding exceeding £3000 of the total issued share capital in the issuer of the shares in question". They also suggest that a publication should disclose if its company has a holding of 5% or more in an organisation whose shares they are recommending.

*What does the term 'securities' in the Code mean?*

The vast majority of publications define "securities" not just as stocks and shares, but include derivatives, contracts for differences and financial spread bets as well. The PCC will interpret the term at its widest, to include any transaction where publication of material may have a potential impact on financial performance.

*What do the terms "recently" and "in the near future" mean?*

It is impossible to define these terms without producing loopholes. To define the term "recently" as one month, for instance, may make dealing in shares about which a journalist has written on day 31 permissible. That is clearly not what it intended. Best practice makes clear that journalists should not speculate by buying or selling shares on a short-term basis if they have written about them in the past or are intending to write about them in the future. Avoiding buying or selling shares on a short-term basis will assist in avoiding problems. In considering any possible breaches of the Code, the PCC will therefore take into account the length of time during which a journalist has held new securities.

## **Disclosure of interests and conflicts of interest**

*What should editors or publishers do when internal disclosure is made to them and they are concerned about a possible breach of the Code?*

Best practice on the majority of publications would be for the editor or publisher to instruct a journalist to unwind a transaction or, if the need arises, to take more serious disciplinary action. Most publications would also instruct a journalist not to deal in a specific share or other security. In order to ensure that the internal disclosure regime is as effective as possible, those who maintain a register of shareholdings, or to whom journalists and editors report, should regularly examine those disclosures that have been made for any sign of irregularity.

*Should there be an internal register of shareholdings?*

Many publications favour a confidential register of holdings by journalists and editors, and this is to be encouraged.

*Should there be "external" disclosure of journalists' financial interests?*

Complete external disclosure of shareholdings to readers is not a practical proposition because of the number of people – from journalists, to sub editors to editors – who may be responsible for what ultimately appears in a publication. However, voluntary external disclosure from the originating writer of an article should be encouraged where appropriate, and when there is any doubt should be considered best practice.

This buttresses the safeguards inherent in internal disclosure and compliance with the terms of the Code of Practice. A general disclosure that journalists may hold or deal in securities reported on is probably of limited value. A specific disclosure that the originating writer holds or has dealt in the securities reported on will be of value to the reader.

*What information should be disclosed by journalists making specific recommendations to readers to buy, sell or hold shares or other securities?*

External disclosure of any significant financial interests or conflicts of interest is advisable in these circumstances. This could be done by publishing a reference to a place where the information is publicly available, such as the paper's website. The reference to where any disclosures can be found could also be made in a standard box referring to the PCC (see below under Investment Recommendation (Media) Regulations 2005).

*Do any particular rules apply to the publication of recommendations made by other people?*

Some publications publish recommendations made by third parties – other newspapers, for example – or summaries of them. If in doing so the publication or journalist changes the direction of any recommendation – for instance, from 'buy' to 'hold' – best practice would be to disclose their own interests or conflicts of interest as outlined above, and to make clear the nature of the change in the interests of accuracy.

There may also be occasions where the direction of a recommendation made by a third party is not changed, but where some other significant alteration is made such as changing the recommended price at which to sell or buy shares. Clause 1 has a relevance here in ensuring that the alteration is made clear, and that readers are aware of the provenance of the original recommendation. If the original recommendation appeared in another newspaper which carried public disclosures of any conflicts of interest, best practice would be either to reproduce these disclosures, or to refer to where they could be found – normally the newspaper's website.

## **Recommendations and accuracy**

Clause 1 (Accuracy) of the Code is particularly important when journalists make recommendations to buy, sell or hold shares, and when newspapers publish recommendations made by third parties. Editors and journalists should ensure that information is presented accurately, that facts are distinguished from interpretations, estimates and opinions, and that care is taken to ensure that sources are reliable.

When publishing recommendations, publications should be as transparent as possible in the interests of good practice. Editors might therefore wish to consider whether, and in what circumstances, it is appropriate for the names of individual journalists who make overt recommendations to be made available (even if this is just via a website).

## **Investment Recommendation (Media) Regulations 2005**

*What are the conditions that exempt publications from the terms of the Regulations?*

These regulations relate to people who make investment recommendations. There are several exemptions. These include where the following two conditions are satisfied:

1. The recommendation appears in a publication that subscribes to a system of self-regulation such as that overseen by the Press Complaints Commission; and
2. The publication concerned carries a 'clear and prominent' reference to the Code of Practice when publishing recommendations.

Some publications may find it easier to publish a general reference to the PCC and the Code rather than to the specific financial rules that it contains. They are free to devise their own reference, but by way of guidance a standard box – which could be published anywhere in the newspaper – might say "This newspaper/magazine adheres to the system of self-regulation overseen by the Press Complaints Commission. The PCC takes complaints about the editorial content of publications under the Editors' Code of Practice, a copy of which can be found at [www.pcc.org.uk](http://www.pcc.org.uk)". If the box appeared on the financial pages, it could also point out that disclosures about any interests or conflicts of interest of the publication's financial journalists appear on its website, if that is the case.

## **Other tests**

Common sense has always been the key to the application of the Code. In this area, many publications apply what they describe as the "Private Eye" test: if it

would embarrass a journalist to read about his or her actions in "Private Eye", and at the same time undermine the integrity of the newspaper, then don't do it.

January 2009

## Memorandum from PPA

### About PPA:

PPA is the association for publishers and providers of consumer, customer and business media in the UK. PPA's role is to promote and protect the interests of the industry in general and member companies in particular. The PPA provides a large number of online services and directories in addition to organising conferences, exhibitions and awards.

The association's membership consists of some 350 members who together publish over 2500 consumer, customer and business magazines and many PPA members offer online services, including websites, online versions of print publications and publications only available online, or through electronic transmission. Online publications also encompass consumer, business to business and customer magazines.

The total value of the UK magazine industry is estimated at £5.7bn, with consumer magazines contributing around £2.8bn, business media (including magazines and directories) around £2.0bn and customer magazines £900m.<sup>18</sup>

Many of PPA's members publish specialist economic and financial titles. It is often the case that national newspapers follow stories which are generated in the specialist magazine press.

A full list of PPA members is available at: <http://www.ppa.co.uk/cgi-bin/go.pl/ppamembers/index.html>

### Executive Summary:

PPA will focus its submission on point **1.11** of the inquiry, which concerns:

**“The role of the media in financial stability and whether financial journalists should operate under any form of reporting restrictions during banking crises”.**

There is a well-known legal maxim that hard cases make bad law. Applying the same maxim to the current financial crisis, it would be extremely hard, and extremely bad, for freedom of the press to be thrown away for the sake of a crisis which, on past form, is likely to appear once in every eighty years.

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<sup>18</sup> PricewaterhouseCoopers' Entertainment and Media Outlook: 2008-2012

Freedom of expression is a right which has been fought for over generations, and is continually under threat. It would be against the public interest for freedom of expression to be compromised whenever there is a banking crisis (however defined).

Furthermore, the public interest requires there to be open reporting of financial matters, because a well-informed public is preferable to a public reliant on partial information. Examination of the period leading up to the Wall Street crisis of 1929 indicates that there was a range of reporting in the press, from belief that economic rules had been rewritten to considerable scepticism about the health and security of the stock market. It is in the nature of financial reporting that there will be a range of views, with, often, hindsight being the only guide to which views are correct. Prior restrictions on financial reporting could easily restrict those comments and views which, with hindsight, turn out to be correct.

The financial institutions themselves, and the Government, have press and public relations staff (funded by the public in the case of Government information) who are well able to present their own views and versions of events. It would be an affront to a free press, and to democracy, if financial journalists were under restrictions while Government press officers were paid by the taxpayer to push the Government line.

It is also, and very obviously, the case that much financial reporting is based on the views of analysts. These views will typically not be consistent and may differ substantially. Any proposal to restrict financial reporting would almost necessarily restrict the publication in newspapers and magazines of some of the views of analysts. These views would nonetheless be semi-public knowledge, in that they would be known to recipients of analysts' briefings and reports, and would almost inevitably find their way on to the internet. The result would be semi-public information without the benefit of editorial comment. The concept of "Government approved" analysts is not one which sits well with a free society.

A free society demands and depends on a free press. A free press may at times be inconvenient, but freedom is not something to be restricted by considerations of convenience.

The idea that restrictions might be suitable in a time of crisis is the sort of idea that typically emerges when there is a crisis. The damaging effects of such an idea being implemented would continue long after the crisis disappeared, and would be a continuing stain on the freedom of UK society.

In more detail PPA will argue that:

- (1) The media should not be restricted from open reporting in times of banking crises. Such restrictions are unjustified and inimical to press freedom and would have detrimental effects for society in the United Kingdom. The media should be freely allowed to report the facts to the public.

(2) Any restriction upon media reporting during banking crises would be likely to be counter-productive - if aimed at preventing or reducing the effect of a banking crisis - and would not be in the public interest.

The suggestion that free reporting might be restricted (under point 1.11) conflicts with the United Kingdom's legal obligations under the European Convention on Human Rights, which safeguards the fundamental human right of freedom of expression.

(3) A restriction on media freedom is in direct contradiction to the government's action plan for 2009 (as highlighted in the Queen's speech) and parliament's drive for transparency.

(4) A restriction on domestic media would commercially disadvantage the UK media in its competition to win audience and might adversely effect its hard won reputation for breadth of coverage and independence.

(5) Any kind of restriction would be impractical and could not justifiably be defended as being in the public interest when it would amount to a restriction of information which the public need to protect their financial security.

(6) A restriction on domestic media would increase rumour and not prevent financial news disseminated from outside the United Kingdom and on The World Wide Web to the citizens of the UK;

In summary, PPA strongly believes that it is the duty of the media to keep the public, including businesses, aware of the latest news; to lawfully investigate the activities and decisions of government, regulators and businesses - including financial institutions. A failure to do so would hinder economic growth and development; the rights of individuals to make informed decisions; would also curtail the fundamental right to free speech and would put media in the United Kingdom at a competitive disadvantage.

### **Reasoning:**

#### **(1) Media Freedom**

A free media is essential to the functioning of a democratic society - providing essential checks and balances - and where necessary exposing dishonesty, corruption, double standards, unfair treatment and failures in transparency required by law.

The media provide a platform through which the public can inform themselves as to the key issues of the day. Any restrictions on honest reporting of financial news would have a serious knock-on effect for the freedom of society.

A restriction on information flow could lead, at worst, to an uninformed society, where news of events in the UK would be replaced by rumour, innuendo and information disseminating from outside the UK; and where accuracy of reports of domestic issues would be less assured, further worsening any crisis. The banking crisis, which the Committee is now investigating, was not caused by media reporting - it was caused by other factors existing in the banking sector which exist in the UK and internationally. These factors were not picked up or caught by the regulatory regimes in place aimed at preventing them.

## **(2) The Law**

Censoring of the media stands in direct conflict with the European Convention on Human Rights, to which the United Kingdom is a signatory (implemented into UK law by the Human Rights Act 1998). We would specifically like to draw the Committee's attention to article 10.1 of the Convention

**"Everyone has the right to freedom of expression. This right shall include freedom to hold opinions and to receive and impart information and ideas without interference by public authority and regardless of frontiers." <sup>19</sup>**

Restraint of the media would constitute a breach of this fundamental human right and would therefore put the United Kingdom in breach of its obligations under the convention. There is no exception to this fundamental human right under Article 10 in the case of banking crises.

The Committee should note that any argument that there should be an exception to Article 10 of the Convention for the economic well-being of the country cannot be sustained as such an exception is expressly made in the case of Article 8<sup>20</sup> related to the Right to Respect For Private and Family Life and has been omitted from Article 10. Article 18 of the Convention importantly states that:

**"The restrictions permitted under this convention to the said rights and freedoms shall not be applied for any purpose other than those for which they have been prescribed"<sup>21</sup>**

## **(3) Government Drive for Justice and Transparency**

The Government's plan for 2009 (as stated in the Queen's speech) included plans to safeguard and increase protection for bank depositors and to improve and bolster the financial sector. The Government is aiming to further protect the public and seeks in this regard to increase transparency in the justice system. If media freedom were to become curtailed, it would not further guarantee protection for bank depositors or even protect the financial sector from further turmoil. While in recent years Parliament has sought to foster

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<sup>19</sup> See appendix for Article 10

<sup>20</sup> See appendix for Article 8

<sup>21</sup> See appendix for Article 18

greater transparency in public life with Freedom of Information legislation, trying to gag the media seems to fly in the face of this wish for genuine transparency.

#### (4) **Media Reporting – the effects**

The complaints about the media (while not expressed in the Committee's Terms of reference in any detail) in relation to this banking crisis generally do not seem to be that the reporting was false.

We have seen no evidence that media reporting accelerated the occurrence of the banking crisis.

The issue of concern seems to be the effect that honest and true reporting of facts has on confidence - that is confidence of the Public and of course confidence in the financial institutions themselves.

Any banking crisis will cause concern and possibly alarm amongst sections of society. Restricting the UK media in times of financial uncertainty would not have prevented or solved the problem of the banking crisis. It might make the crisis worse, in that absence of information can create a vacuum which is filled by rumour.

Restrictions of the UK media would damage the reputation of the media themselves and of the UK generally. UK media would cease to be trusted by the public and its competitors abroad would be given a competitive advantage; the UK itself would risk losing reputation and influence and might indeed find that its government securities held less value, with a consequent negative effect on the UK economy.

The causes of the banking crisis are not media reporting but rather the failure of banking institutions to operate and regulate themselves properly, tied in ultimately with the failure of regulatory regimes around the world to protect the public.

#### (5) **Practicalities**

If the media were to be restricted who would decide what constituted a banking crisis? Would it be a regulator? Would such a decision itself cause a crisis of confidence? Would it be reviewable by the court? How would damaging and possibly false rumours be prevented from filling the void of information? How would the dissemination of information on the World Wide Web and from abroad be prevented? What would happen when the restrictions on the media were lifted?

Restricting the media cannot be justified in the public interest, when it amounts to restriction of information which the public need to protect their financial security and to make informed choices.

### **Conclusion**

Freedom of the media is one of the measures of the well-being of any democratic society. Any attempt to curb this freedom would be detrimental to the UK economy, UK society, UK Media and the standing of the UK globally.

### Appendix:

European Convention on Human Rights:

#### **ARTICLE 8**

1. Everyone has the right to respect for his private and family life, his home and his correspondence.
2. There shall be no interference by a public authority with the exercise of this right except such as is in accordance with the law and is necessary in a democratic society in the interests of national security, public safety or the economic well-being of the country, for the prevention of disorder or crime, for the protection of health or morals, or for the protection of the rights and freedoms of others.

#### **ARTICLE 10**

1. Everyone has the right to freedom of expression. This right shall include freedom to hold opinions and to receive and impart information and ideas without interference by public authority and regardless of frontiers. This article shall not prevent States from requiring the licensing of broadcasting, television or cinema enterprises.
2. The exercise of these freedoms, since it carries with it duties and responsibilities, may be subject to such formalities, conditions, restrictions or penalties as are prescribed by law and are necessary in a democratic society, in the interests of national security, territorial integrity or public safety, for the prevention of disorder or crime, for the protection of health or morals, for the protection of the reputation or the rights of others, for preventing the disclosure of information received in confidence, or for maintaining the authority and impartiality of the judiciary.

## **ARTICLE 18**

The restrictions permitted under this Convention to the said rights and freedoms shall not be applied for any purpose other than those for which they have been prescribed.

January 2009

## Memorandum from CRESC

### Rediscovering banking as utility

Ismail Erturk, Julie Froud, Sukh Johal, Adam Leaver and, Karel Williams  
(ESRC Centre for Research on Socio Cultural Change, University of Manchester)

#### Executive Summary:

- This submission presents argument and evidence which suggests that banking is not a suitable activity for shareholder value driven PLCs.
- It shows how the pursuit of shareholder interests from the 1980s onwards encouraged new business models which undermined banking's basic utility functions and damaged the interests of depositors and borrowers.
- The crisis since 2007 dramatises the need for new policies of damage limitation as long as PLC organisation and shareholder value prevail and also for more radical policies to encourage the remutualisation of banking.

### Rediscovering banking as utility

*“we will deliver significant increases in shareholder value from the continuing application of our profit formula”*  
(statement of HBOS aims by CEO Andy Hornby in March 2007)

*“an organization offering financial services, especially the safe keeping of customers money until required and making loans at interest”*  
(definition of a bank in the Oxford English Dictionary)

1) The two quotations above offer different definitions of banks and banking. If we turn to what banks were saying before 2007 when explaining their purpose and achievement to the capital market before the current crisis, we find that banks are defined as machines that deliver value to shareholder to the capital markets; thus, the emphasis of CEOs like Andy Hornby right up to the present crisis was about how their business models could deliver “sustainable growth” for shareholders. But if we consult the OED on established usage, and then cross check against textbooks on money and banking, we find that banks are defined differently as public utilities because the emphasis is on their essential functions for depositors and borrowers in any kind of monetised capitalist economy; these definitions fit with the public expectation that (retail) banks should serve depositors by safe keeping money and organising payments as well as serving borrowers by providing loans for firms and households.

2) The quotations are also about practices with implications for all of us. In the financial crisis since 2007, the government wants banks to deliver on their utility obligations to customers and thereby serve the economy as a whole. The crisis

began in the UK with a run on deposits at Northern Rock and afterwards in all high income countries the growing fears of depositors could only be assuaged by an extension of public schemes for guaranteeing bank deposits. By late 2008, the crisis had turned into one of deleveraging which incidentally meant that many averagely responsible borrowers were frustrated as they found that banks were cutting credit lines to SMEs and disrupting the housing market by imposing new requirements for deposits. Put simply, banking as utility has failed to do what all of us as depositors and borrowers previously took for granted. And, in this submission we want to ask whether, in terms of the TSC call for evidence, the current failure to protect customers arises from the earlier pursuit of shareholder interests.

3) Put another way, this submission raises the question of whether banking is a suitable activity for shareholder value driven PLCs. The evidence may not be conclusive but our argument is that the business models of banking for shareholder value do interfere with the discharge of the basic utility functions. If so, it will be necessary to consider not only the propping up of PLC banking at taxpayer's expense on the Brown Darling model but also a more fundamental reinvention of mutual banking for depositors and borrowers. The British government's bank bail out plans for re-capitalisation and public shareholding were a major advance on the original US Paulson proposals for acquiring troubled assets. But, as the subsequent skirmishing on dividends and bonuses demonstrates, the British government has extended public ownership temporarily without any clear governance objectives other than exit which is predicated on the assumption that in the longer term it should be shareholder value business as usual whenever the crisis lifts.

4) In questioning this assumption, we organise our submission in a relatively straight forward way into three sections. The first considers the indirect evidence of changing banking business models since the early 1980s; the second section considers the role of shareholder value pressures in changing banking behaviour; and the third section briefly reviews the implications for policy and conventional problem definitions.

## **(1) New business models since 1980**

1.1) If a corporate business model is a plan or formula for making profit for shareholders, it is difficult to generalise about banking business models given the variety of activity in retail and investment banking and the diversity of firm types from small specialists to giant conglomerates. But, it is possible to say something indirectly about changing business models, if we remember two points. First, change in business model will show up as changes in sources of income and balance sheet within or across national boundaries or by type of firm. Second, banking as utility for depositors and borrowers has a characteristic configuration in terms of income sources because, where utility banking is in the ascendant, the dominant source of income is interest income earned on the spread between what banks pay depositors and charge borrowers.

1.2) If we make no distinction between different types of banks, but consider all banks in the high income countries since 1980, then one interesting change immediately stands out, classic intermediation between depositors and borrowers is apparently of declining importance if we consider sources of income. Table 1 below shows that non interest income is increasingly important to banks in all the high income countries. The simple average share of banks' non-interest income in six countries has risen from 25.5 per cent in 1984 to 40.7 per cent in 2003; and the UK starts and ends above the average in this league table.

**Table 1: Net non-interest income of credit institutions (in per cent)<sup>1</sup>**

	1984	1990	1995	2000	2003
France	n.a.	22.6	45.5	60.9	56.7
Germany	18.0	26.8	21.0	35.8	27.1
Netherlands	24.7	28.4	33.3	47.0	39.2
Italy	24.6	22.0	19.8	36.1	30.2
UK	35.6	38.7	42.7	43.2	46.4
USA	24.7	33.0	35.3	42.8	44.6
<b>Simple average</b>	<b>25.5</b>	<b>28.6</b>	<b>32.9</b>	<b>44.3</b>	<b>40.7</b>

<sup>1</sup>The share of non-interest income in total net non-interest income and net interest income of all financial institutions -excluding the Central Bank- and their main legal categories: commercial banks, co-operative banks, savings banks, municipal financial institutions, finance companies and specialised financial institutions. The UK and USA data is for commercial banks only.

**Source:** OECD, *Bank Profitability Statistics*, <http://www.oecd.org/statsportal/>

1.3) "Net non-interest income" represents many kinds of fee earning services which have become more important because of a retail revolution and not unrelated developments in investment banking. If we begin by considering retail, individuals and households were once defined as customers with bank accounts who variably combined small savings deposits, users of cheque accounts and occasional borrowing all on the bank's balance sheet, so that intermediation between households (and firms), along with differences in borrowing and lending rates, were the major source of profit. Since the 1980s individuals and households are now being redefined as consumers of financial services products like mortgages, insurance, savings and pension plans, which mostly generate fees when sold; while the interest-related income from repayments of revolving debt and mortgages will not accrue to the originator if the loan is securitised. In the UK, the breakthrough fee generating product was the endowment mortgage of the 1980s. Banks were then reconfigured with selling cubicles as the banks found a new opportunity in mass retail where they were not so much intermediaries as primary corporate actors just like other high street chains.

1.4) Though the fee based retail revolution is manifest and important, UK banks continue to earn just over half their income from interest and, significantly, half or more of that interest comes from household borrowers not firms. If we examine the loan portfolio of UK banks, we see that they are not in the business of intermediating between depositing households and borrowing productive firms because non-financial firms have since 1980 have accounted for 30% or less of bank lending. The largest group of borrowers has always been households who historically in the UK since the 1960s have always accounted for half to two thirds of bank lending. Since the early 1980s, the major new development in lending could be described as finance feeding finance because the share of “other financial corporations” in bank lending steadily increased from 9 per cent to a remarkable 24.4 per cent by 2005.

**Table 2: Share in total net sterling lending by the U.K. monetary financial institutions (in per cent)<sup>1</sup>**

	1963	1970	1975	1980	1985	1990	1995	2000	2005
Private non-financial Corporations	38.3	38.3	34.8	30.6	23.4	25.1	19.8	20.6	21.2
Households	57.4	59.0	58.3	60.8	67.2	60.9	62.3	56.2	54.4
Other financial corporations	4.3	2.7	6.8	8.6	9.4	13.9	17.9	23.1	24.4

<sup>1</sup>Total net sterling lending is the sum of lending to non-financial private corporations, households and other financial corporations.

**Source:** own elaboration based on data from Bank of England, Monetary financial institutions’ balance sheets, income and expenditure, <http://www.bankofengland.co.uk/statistics/index.htm>

**1.5) Why has the demand of financial corporations for bank borrowing increased so massively? Because, after the 1980s, stand alone investment banks and the investment banking divisions of banking conglomerates (and many other actors eg private equity and hedge funds who used banks) reinvented themselves as players who levered their gains with borrowed money. In the case of investment banks, the result was that their traditional sources of income from issuing securities and advising on M and A became much less important. Table 3 below demonstrates this by considering two stand alone investment banks (Goldman Sachs and Lehman Brothers) where traditional investment banking by the late 1990s already accounted for less than one third of revenues.**

Table 3: A breakdown of revenues in two leading investment banks: Goldman Sachs and Lehman Brothers

		1997	1998	1999	2000	2001	2002	2003	2004	2005
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<b>Goldman Sachs</b>	Investment banking	35%	46%	27%	32%	24%	20%	17%	16%	15%
	Principal transactions and trading	39%	25%	47%	40%	40%	38%	65%	65%	66%
	Asset management and securities services	26%	29%	26%	28%	36%	42%	18%	19%	19%
Lehman Brothers	Investment banking		34%	31%	28%	29%	28%	20%	19%	20%
	Capital markets		51%	58%	61%	60%	59%	70%	66%	67%
	Client services/investment management		15%	11%	11%	12%	13%	11%	15%	13%

Source: company annual report and accounts

Notes:

For Goldman Sachs, the segments are defined as follows

*Investment banking*: advice to clients on M&A, corporate defence, restructuring etc; plus underwriting public and private placements of equity and debt.

*Trading and principal investments*: making markets and trading in interest rate and credit products, mortgage-backed securities and loans, equities and equity-related products, equity derivatives, currencies and commodities, proprietary trading etc; corporate and real estate merchant banking investments.

*Asset management and securities services*: investment advisory and planning services etc across all major asset classes to institutions and individuals and generating fee revenues; prime brokerage services, financing and securities lending services, generating interest rate spreads and fee revenues.

For Lehman Brothers, the segments are defined as follows

*Investment banking*: advice to clients on M&A and other financial matters; capital raising for clients via underwriting debt and equity issues.

*Capital markets*: institutional sales, trading, research and financing activities in equity & fixed inc cash and derivatives products; market maker in various products eg government and corporate bonds, asset-backed securities and mortgage-backed securities, forex & derivatives; risk arbitrage & secured financing plus private equity gains and losses.

*Client services:* private client revenues from high net worth customers; private equity management & incentive fees (where Lehman is general partner for 33 PE partnerships).

1.6) The reinvention of investment banking and the retail revolution were symbiotically inter-related. Increasingly fee driven mass retail banks did not want to retain the results of transactions on their own balance sheets and were attracted by securitisation through which they could pass loans on and then return to the market place to make another fee earning sale; thus, mass retail provided the feed stock for an increasingly frenetic and ramshackle structure of prop trading through collateralised loan obligations and credit default swaps which generated fees at every stage for investment bankers. Before this ended with the sub prime debacle, the changes in retail and investment banking promised higher ROE which was the key sectoral performance measure for bank analysts and managements that sought stock market approval.

1.7) In a final phase, when the Fed cut US interest rates after the tech stock crash in 2000, policy initiated a new conjuncture of cheap credit and excess liquidity which produced an asset price bubble and Minskian credit cycle. While the going was good from 2000 to 2007, the long run changes in sources of income continued as business models were adapted to new opportunities. This point can be demonstrated in a variety of ways from the available evidence. The Bank of England series on US and European “ Large Complex Financial Institutions” shows that trading profits and fees increased more sharply amongst this group of giant conglomerates ([www.bankofengland.co.uk/publications/fsr/2007/fsrfull0704.pdf](http://www.bankofengland.co.uk/publications/fsr/2007/fsrfull0704.pdf)). We can then see the pattern of broadly based change across the sector if we consider six individual cases of major UK and US banks with diverse sources of fee income arising from different portfolios of retail and investment activity when Lloyds, for example, is retail only but Barclays has a large prop trading operation. In five of the six cases non- interest income grows faster and the exception is Citi which starts with the highest ratio of non-interest income. The differential in growth rates is such that by 2007 all six banks have more non-interest than interest income; whereas in 2000 only three of the six were in this position; By 2007, these sector wide changes had been pressed so far that, in balance sheet terms, several fee earning majors with investment banking income no longer looked like banks where loans to customers have traditionally dominated the asset side of the balance sheet: in 2007 loans still accounted for more than half of assets in Lloyds and HBOS whereas at RBS and Barclays loans accounted for no more than 44 and 28% of assets.

**Table 4: The rise of non interest income in six major UK and US banks 2000-7**  
**(£000,000 for UK banks and \$000.000 for US banks)**

	Net interest income		Growth	Non-interest income		Growth	Non-interest income//Interest income	
	2000	2007		2000	2007		2000	2007

<b>Lloyds-TSB</b>	4,587	6,099	33.0%	3,882	12,129	212.4%	84.6%	198.9%
<b>Barclays</b>	5,155	9,610	86.4%	4,443	13,882	212.4%	86.2%	144.5%
<b>HBOS<sup>1</sup></b>	4,173	7,304	75.0%	2,699	13,987	418.2%	64.7%	191.5%
<b>RBS<sup>2</sup></b>	5,787	12,668	118.9%	6,321	18,447	191.8%	109.2%	145.6%
<b>BoA<sup>3</sup></b>	18,442	34,591	87.6%	14,489	37,989	162.2%	78.6%	109.8%
<b>Citi<sup>3</sup></b>	28,301	39,554	39.8%	46,887	50,061	6.8%	165.7%	126.6%

**Notes:**

<sup>1</sup>2001 not 2000

<sup>2</sup>for 15 months ended 31 December 2000

<sup>3</sup>2006 not 2007 because Citi and BoA reported losses on non-interest income generating businesses in 2007 due to financial crisis and therefore 2006 figures were used for comparative purposes.

**Source:** Annual Reports

**(2) Shareholder value as the driver**

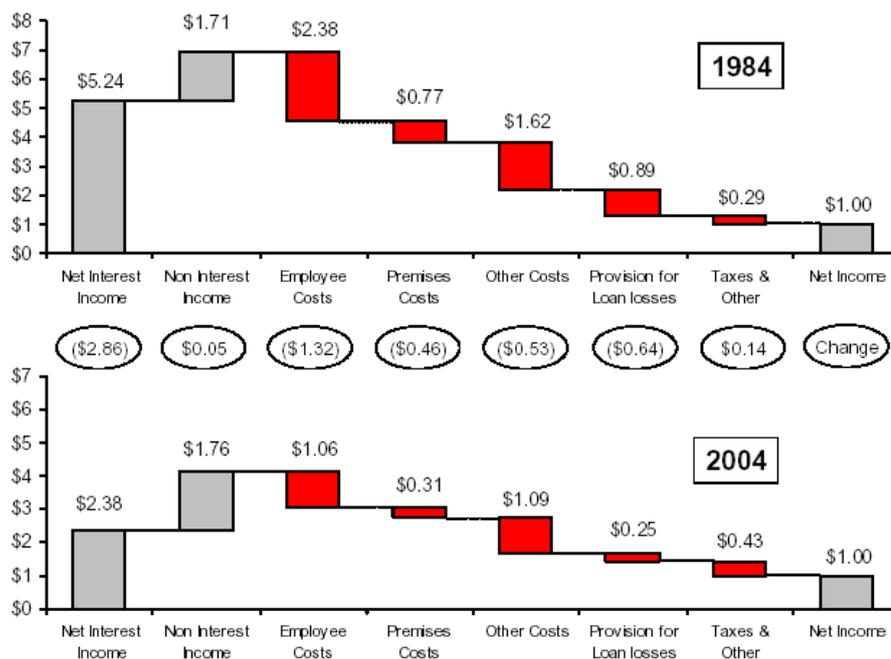
2.1) If shareholder value is the driver of business model change, we must recognise the complexities of this process. The pursuit of shareholder value generally involves process and outcomes specific to time and place; thus, our earlier comparative work on giant firms demonstrated that shareholder value in the FTSE 100 meant slow sales growth while across the Channel in the CAC 40 it was associated with high growth rates as French corporate management went on an international acquisition spree. In the case of changing bank business models, the complex processes and effects need to be understood in the context of opportunities and constraints established by changes in frame and conjuncture. Hence, in the case of changing retail business models, push factors and the increasing difficulty of making profits through intermediation were probably more important than pull factors and the opportunities of easy profits from marketing. In investment banking the opportunities were practically and culturally channelled by a set of confusions about risk and uncertainty which influenced investment banks and through Basel 2 regulations influenced their retail counterparts..

2.2) In retail, push factors provided the impetus for changing business models because the easing of commodity price inflation by the early 1990s plus intensified retail competition after deregulation had the unintended effect of undermining the profitability of established intermediation activities. With low interest rates and more competition, it was simply much harder to make profits on the spread between borrowing and lending; Greenspan's interest rate cuts in the US after 2000 or the coordinated international cuts after 2007 appear to have inaugurated a period of permanently low interest rates around 1-2% and ensured intermediation will only be modestly profitable for the foreseeable future. Pull factors are then relevant because there were marketing opportunities to cross-sell financial services to an inert customer base when, as Cruickshank noted, the average Brit is more likely to divorce than to change banks. But, as with most mature businesses, the returns to effort from direct mail shots and such like were always disappointing

2.3) Table 4 above on non interest income demonstrated that the conjuncture from 2000-7 was one of buoyant banking revenues of all kinds when fee based non interest income increased faster than interest income which nevertheless also increased by one third or more at each of these major banks. But in the longer term, if we isolate margins from volume, the dynamics of business model change are rather different because declining margins on interest rate spreads are very important. These margin issues need more research, but Dener's comparison of US commercial banks income and cost structures in 1984 and 2004 in exhibit 1 is suggestive. In the longer term in the US case, the change of business model is initiated by an external, structurally driven decline of margins rate spreads; fee income then fails to compensate despite a huge management effort in marketing; and margins can only be maintained by cost reduction at the expense of the workforce and the branch networks. This analysis helps to explain the apparent paradox of intensification and permanent restructuring for the mass workforce and limited gains in numbers employed in the recent golden age of finance. If the US margin trends are replicated in UK retail, the conclusion is that retail management in banking is less in control of any kind of "profit model" than it claims to be; and, in the long term, is covering its positive failure to create shareholder value on the margin with the negative of cost reduction plus a search for volume..

**Exhibit 1: income and cost structures of US commercial banks 1984 and 2004**

US commercial banks - How to make a \$1 in 1984 and 2004



Source: FDIC, Capco Analysis  
 Note Taxes & Other – "Other" is Extraordinary items and Securities Gains & Losses

Source: Dener, A et al. "A bad situation getting worse- the US banking profitability crisis" The Journal of Financial Transformation, Vol 17, at [www.capco.com/?q=content/journal-detail&sid=67](http://www.capco.com/?q=content/journal-detail&sid=67))

2.4) In discussion of what caused the crisis in investment banking, critics have generally focused on issues like bonus systems and Basel 2 not on the driving force of shareholder value. These critics have a point. The bonus system for senior investment bankers was egregious because it rewarded in cash those who took risks with borrowed money to create what Rajan has called “ fake alpha”; regulation in the form of Basel 2 was also culpable because it encouraged risk passing behaviour by retail banks which created all those dodgy off balance sheet assets. But we only get a satisfactory explanation if we consider these two variables jointly and explain how they interacted with shareholder value which provided the dynamising force. The implication of this analysis is that shareholders were not so much the unwitting victims of the crime but the co-conspirators who should figure on any indictment.

2.5) To begin with, the stand alone investment banks and the investment banking divisions of conglomerates were effectively being run as joint ventures between the bonus drawing senior bankers and the dividend drawing shareholders. Profit sharing was explicit when analysts and others discussed the so called “comp ratio” ie the understanding that compensation would account for 50% of revenue. Investment bank shareholders (or anyway their fund managers) abandoned the hitherto sacrosanct principle that the (risk taking, equity providing) shareholders of public companies had the sole interest in the residual after operating costs had been met. They did so because ex ante they hoped that suitably incentivised managers would create shareholder value and only ex post realised that they had entered into a contract with the sorcerer’s apprentice. And before the crisis of 2007-8, the shareholders were just as culpable as the managers because they too cashed out their dodgy profits year by year. Table x below summarises the sectoral sources of profit in the FTSE 100 in the bubble years of the 2000-2007 and shows the importance of commodities and financial services profits: the “ finance insurance and real estate” sector is almost all financial services in the form of banks and insurance companies which together accounted for around one third of total FTSE profits in these years.

**Table 5. Sectoral contribution to FTSE100 profits, 2003-2007**

	Profit before tax £ mill				% Share contributed by sector		
	FTSE 100	FIRE	Oil	Mining	FIRE	Oil	Mining
2003	72,961	31,068	20,720	4,633	42.6	28.4	6.3
2004	116,294	37,047	27,741	8,246	31.9	23.9	7.1
2005	150,986	48,648	43,229	15,051	32.2	28.6	10.0
2006	165,632	58,839	41,674	23,223	35.5	25.2	14.0
2007	171,484	52,168	41,946	26,426	30.4	24.2	15.4

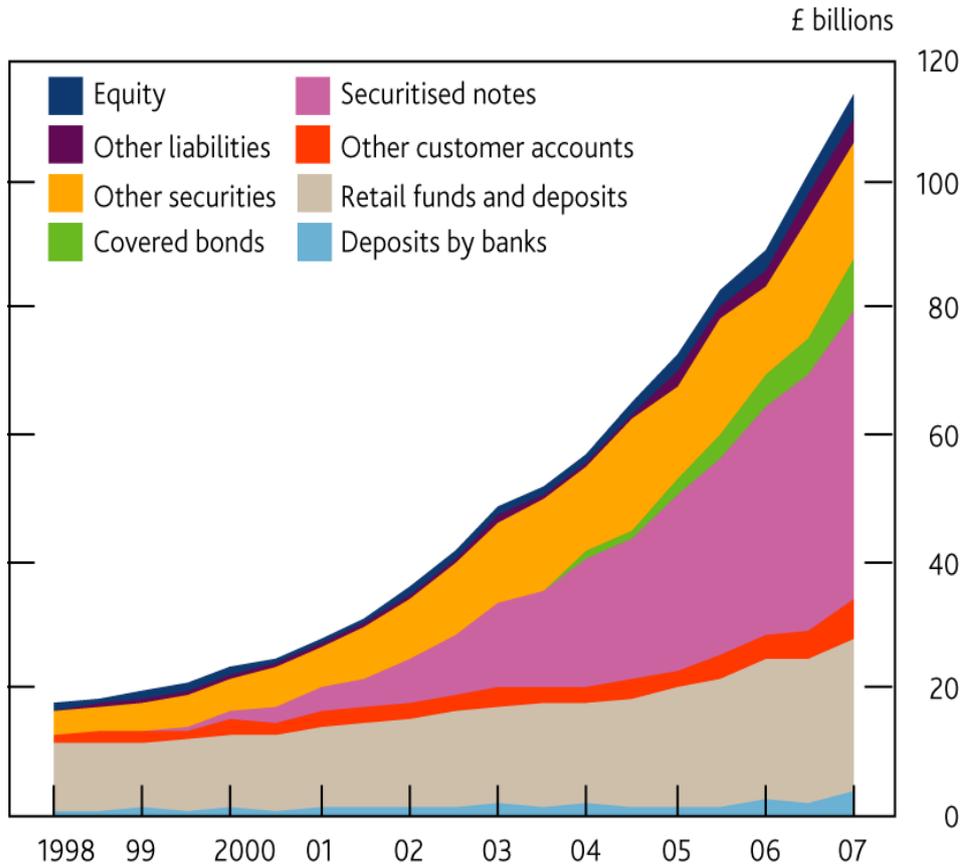
Sources: Datastream, FAME and Mergent

Note: FIRE = finance, insurance and real estate

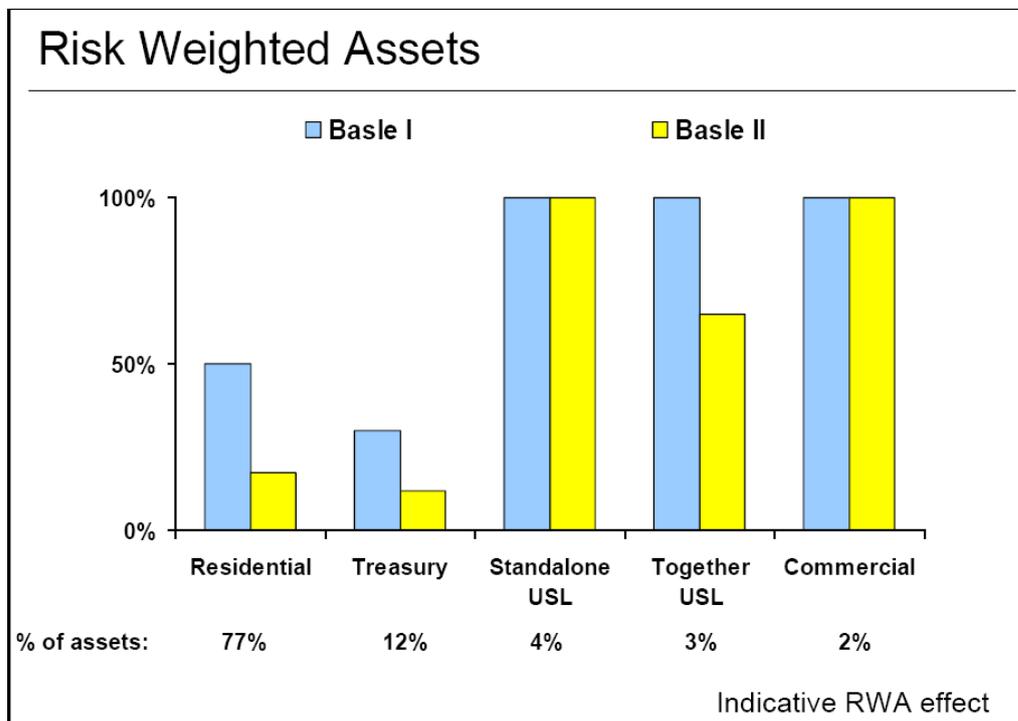
2.6) In combination with more general cultural confusions about risk, regulation then became a secondary encouraging force because it created incentives for fee based bricolage and moving things off balance sheet. The old distinction between incalculable uncertainty and probabilistic risk had been lost with the intellectual defeat of Keynesianism; and after the 1980s mainstream finance increasingly constructed everything as probabilistic risk and developed sophisticated models of Value at Risk. These models, on the basis of recent and benign experience, purported to capture all types of risk from operational to market, in a numerical measure which investment bank managers of trading operations could easily understand. The conventional wisdom about probabilistic risk was fed into the Basel regulations after 1996 which varied capital reserve requirements for retail banks according to the supposed risk of the type of activity. Basel 2 encouraged banks to keep fewer loans on balance sheet through securitization and by engaging in trading and investment activities in money and capital markets which both reduced the requirement for regulatory capital.

2.7) If regulation created loopholes and perverse incentives, it was shareholder value which drove banks to exploit them on a heroic scale driver. Shareholder value driven banks represented themselves partly through Return On Equity calculations because bank equity analysts paid particular attention to ROE in bank valuation and judging value creation. Banking is a business where money is made from taking risks and (equity) capital is the scarce resource which limits activity and covers risk; so ROE in banking was the generally preferred measure for making firms intelligible and comparable (like product pipeline in pharma firms). The business model shift to fees, securitization and prop trading was then win win in numerator and denominator terms which made it much easier to generate higher returns on a (sometimes smaller) equity. In retail, for example, expansion of the new activities brought in more income and reduced the requirement for regulatory capital because fee generating activities did not require as much regulatory capital as lending activities and securitization directly reduced the requirement under Basel 2. Exhibit 2 below shows how Northern Rock increased leverage and expanded assets at astronomic rates by drawing on wholesale funds not retail deposits; exhibit 3 then shows how under Basel 2 the capital requirements on residential loans securitized within credit default swaps were much lower on the 77% of Northern Rock assets in these loans.

### **Exhibits 2 and 3 Northern Rock's Business Model**



Source: Bank of England, Financial Stability Report 21 (April 2007) available at <http://www.bankofengland.co.uk/publications/fsr/2007/fsrfull0704.pdf>



Source: [www.companyinfo.northernrock.co.uk/investorrelations/results/](http://www.companyinfo.northernrock.co.uk/investorrelations/results/)

### **(3) What is to be done?**

3.1) If we change problem definitions and challenge existing organisational forms and objectives, it is more difficult to come up with policy answers because ameliorative fixes usually assumes a world taken for granted. The problems are compounded if, as we have argued elsewhere, there are general difficulties about controlling financial innovation in each new conjuncture. So, in this concluding section, our intention is not to articulate detailed policy prescriptions or a new set of banking regulations, but to identify two key issues that need to be considered when rethinking banking for the next conjuncture and beyond. The first issue is about the relation between retail and investment banking as long as the existing PLC form and shareholder value objectives prevail; the second issue is about how retail banking could and should be organised if new kinds of mutual organisation were to be encouraged in banking.

3.2) As long as the PLC form and shareholder value objectives prevail, the British government should consider re-establishing a separation of retail and investment banking of the kind which was enforced in the United States by the Glass Steagall Act until it was abolished by ill considered deregulation. The reason is simply that investment banking is the opaque, risky, innovative, hard to control activity which should not be allowed to cover its prop traders' risk taking with retail balance sheets whose solidity results from ordinary customers prudence in depositing savings and responsibly paying back loans. In terms of shareholders v customers, the inequity here is that shareholders (and senior managers) get all the gain on the upswing of the credit cycle by drawing down the profits of investment banking; while utility customers share the pain on the downswing as they suffer higher costs of borrowing and increased charges on deposit and current accounts as all banks try to repair balance sheets and cover lost profits (while distressed banks charge losses to the tax payer).

3.3) This message is underscored by the nature of the present crisis in banking and the completely inappropriate defensive response of encouraging mergers which cover investment banking problems with retail balance sheets. Those banks which have collapsed, or needed bailout funds to avoid serious problems, generally have problems arising from investment banking. Some banks like Bear Sterns and Lehman failed because their investment banking operations did not control risk and anticipate uncertainty in the wholesale markets after creative securitization had been used alchemically to produce investment grade securities; other banks failed because they ran retail banking operations which, like Northern Rock, sought to transform themselves through aggressive, wholesale funded securitization. In all these cases the problem is creative and aggressive shareholder value driven securitization which is rather different from socially responsible securitization as originally used by the US car companies or Fannie Mae and Freddie Mac.

3.4) The defensive policy response is then to hide failure and risk in a retail balance sheet as in the proposed UK merger of troubled HBOS with retail only Lloyds in the UK, the US merger of J P Morgan Chase and Morgan Stanley or the move to allow the few remaining investment banks like Goldman Sachs to convert themselves into bank holding companies. We cannot rely on regulators to enforce prudence in the new conglomerate behemoths because the last set of risks and uncertainties were beyond the comprehension and management of regulatory authorities across the world and fairly predictably the next set of risks and uncertainties will be different. Nor can we rely on an analysts to judge the when the analysts who in 2008 greeted Lloyds as a smart, “save the day” hero had two years previously been criticising Lloyds for its strategic timidity and operational conservatism. Meanwhile, policy will have created larger and more opaque hybrid investment cum retail banks whose bail out by tax payers will cost more in the next crisis.

3.5) If the coupling of retail with investment banking raises problems for the customers of utility retail and for taxpayers, the more fundamental questions concern the appropriateness of a shareholder value model for retail banking and the possibility of a more radical policy which would encourage a utility model partly through remutualisation of retail banking. In the Thatcher years and afterwards, an uncritical one size fits all approach encouraged the adoption of the PLC form and shareholder value in all activities. Thus, the publicly owned utilities like electricity, gas and water supply were purposively privatised and the mutually owned utilities like the building societies with savings and loans businesses were permissively demutualised. Few asked whether the fundamental characteristics of utility businesses (large capital entry investments and/or other limits on competition, steady but modest returns from socially essential services) made the model of PLCs for shareholder value inherently unsuitable for these areas .While orthodox economists with misgivings about the absence of competition, recommended tough regulation of prices in relation to costs which was likely to spoil margins completely.

3.6) Retail banking has utility-like characteristics in terms of its provision of essential (intermediation) services, especially secure cheque and deposit accounts and appropriate credit to consumers; and, as we have argued, margins are inherently slender on such business as long as nominal interest rates remain low. In this case the question which advocates of shareholder value must answer is straightforward: where are the continuous organic increases in profit and turnover to come from, if not at the expense of customers (before the taxpayer is billed for the costs of bail out).

3.7) Labour cost reduction, branch closure and such like degrade work conditions and inconvenience customers but generates little leverage when everybody has been playing this game with cost structures for some time.. Marketing encourages a preoccupation with market segmentation which can mean worse service for unprofitable consumers plus confusion pricing as in the rate of interest on credit cards, commission and incentives encourage mis-selling of products that do not meet customer needs. Endowment mortgages and personal pensions are the prime UK examples. It is hard to avoid the inference

that, in the activity of retail banking, shareholder value is not so much found as made at the expense of workforce and depositors and borrowers. As we have now found out, the process is also unstable because shareholder value driven banking forces bank management to aim for unrealistic and unsustainable profits with target ROE of 25% at a major conglomerate like Deutsche Bank.

3.8) If banking is not a suitable business for shareholder value, it is encouraging to find that we could gain the benefits of an alternative kind of banking without incurring the costs of abrupt, large scale organisational regime change. Remutualisation of retail banking in the 2010s can learn from the disappointment with nationalisation of basic industries in the 1940s and with privatisation of utility services in the 1980s where unrealistic expectations about new ownership were frustrated by complex circumstances and unintended consequences.. Remutualisation could be a gradual change which worked through the euthanasia of the shareholder and does not depend on creating high performance organisational forms which are superior to the PLC

3.9) If retail was deliberately separated from investment banking, M and A was discouraged and customer friendly regulation on access to banking was enforced, the stock market would have to come to terms with modest yields and future expectations of profit. Retail bank shares would become something more like investment quality bonds which could usefully be part of institutional portfolios and incidentally we would permanently remove one of the main causes of profits and asset price bubbles. If shareholder value is apparently powerful as a justificatory rhetoric, it is not robust in the material world. If the cash flows are cut off and there is no promise of profit, then shareholder value will wither away and no formal expropriation of private owners would be necessary. It might be sensible in the long term to substitute bonds for shares in utility banks so that pension fund investors could gain predictability and security of returns on a class of paper whose quality could be second only to government bonds.

3.10 Remutualisation would also involve experiment with new kinds of mutual organisations like savings and loans and encouragement of old kinds of mutuals like building societies and credit unions to offer competitive internet and branch alternatives to the PLC high street bank chains. We are not discouraged by the argument that an earlier generation of mutuals were often slow moving organisations, dominated by modestly paid management with limited imagination and capacity for innovation. If banking is to be remade as a boring business which dependably serves customers, much of this would not be such a bad thing. With shareholder value we have been living through a kind of experiment in recreating the PLC as a high performance organisation which can internally combine strategic innovation and risk management with external responsiveness to shareholders. Much of this is probably impossible and in retail banking it is also unnecessary and undesirable.

January 2009

## **Memorandum from ICAS**

### **SECURING FINANCIAL STABILITY: THE ROLE OF AUDITORS IN THE BANKING CRISIS AND WHETHER ANY REFORM TO THAT ROLE IS DESIRABLE**

#### **1. The Institute of Chartered Accountants of Scotland**

- 1.1 The Institute of Chartered Accountants of Scotland (ICAS) is pleased to submit written evidence to the Treasury Committee. Please note that we would also be pleased to provide oral evidence to the Committee on this subject.
- 1.2 ICAS is the world's first professional body of accountants, receiving its Royal Charter in 1854. ICAS has over 17,000 members worldwide and in the UK the CA designation is reserved exclusively for their use. A considerable number of our members work as auditors, as preparers of financial statements and as investors. We therefore believe that we have the required expertise to provide evidence on this topic.
- 1.3 The objective of ICAS is to uphold the integrity and standing of the profession of chartered accountancy in the interests of society and the membership, through excellence in education and the development of accountancy and through service to members and the enforcement of professional standards.
- 1.4 As the Institute's Charter requires, we act in the public interest, and our proactive projects, responses to consultation documents etc. are therefore intended to place the general public interest first, notwithstanding our charter requirements to represent and protect our members' interests.
- 1.5 In the context of the role of the auditor we consider the public interest to be maintaining and promoting confidence in both auditors and the audit market, in the quality of audit, and in effective regulatory oversight.
- 1.6 In recent years, ICAS has campaigned for the development of a more principles-based financial reporting framework, building on the Institute's influential 2006 report 'Principles not Rules: A Question of Judgement'. The arguments for principles rather than rules also apply to auditing standards and the regulation of the audit profession and we believe that it is vital that a principles-based approach is adopted when considering any potential reforms to the auditor's role.

#### **2. Executive Summary**

- 2.1 The term 'audit' is widely used but, in our view, is not widely or fully understood, leading to an expectation gap about what is involved in the statutory audit of financial statements. It is important to recognise that

financial statements, and therefore the auditor's opinion involve significant levels of estimation and judgement and are therefore not absolutely precise, and that the auditor does not give an opinion on the future financial wellbeing or prospects of a company.

- 2.2. In considering any proposed reforms to the auditor's role, it should be noted that UK auditors operate in a largely global regulatory environment. In this context, we recommend the following areas for further consideration.
- 2.3 We support further work being carried out to address the expectation gap that exists between auditors and users of audit reports.
- 2.4 A statutory limitation of liability for auditors is required in order to allow auditors to improve the quality and usefulness of the audit report to users. We recommend that the legislation should be enacted to provide for proportionate limitation of liability on a statutory basis.
- 2.5 We believe that audit quality is enhanced by a principles-based approach to auditing standards, which permits auditors to exercise their professional judgement, thereby allowing them to see the 'big picture', rather than focussing on compliance with detailed rules. This type of approach is essential in assisting the audit profession to work to enhance the quality and value of the audit.

### **3. The role of the auditor in the capital market & the banking crisis**

- 3.1 The role of an audit and the relative responsibilities of the various stakeholders in the capital markets may need to be clarified. The term 'audit' is widely used but, in our view, is not widely or fully understood, leading to an expectation gap about what is involved in the statutory audit of financial statements, and the assurance it provides.
- 3.2 The directors of a company are responsible for preparing annual financial statements which give a true and fair view of the company's financial performance and position, in accordance with the relevant accounting standards and company law. A 'true and fair view' means that the financial statements are a neutral and honest reflection of the performance over the year and the position at the year-end. Encapsulated within this requirement is the recognition that financial statements cannot be absolutely precise – they include many subjective judgements made by the directors as well as the results of precise transactions.
- 3.3 While the responsibility for the financial statements lies with the directors, people who use the financial statements need to have confidence in what is being presented by the directors. For this reason, UK law has since the 19<sup>th</sup> century required the directors to obtain a 'second opinion' from an outside expert – the auditor. Credibility is given

to the financial statements because of the auditor's training, experience, integrity, professional judgement and independence.

- 3.4 The auditor reports to a company's shareholders, who are responsible for the appointment of the auditor, as to whether the financial statements give a true and fair view. We should like to note two points that are, in our opinion, misunderstood about the audit opinion. First, financial statements are not absolutely precise. Similarly, the auditor's opinion is not absolutely precise either – it requires the use of professional judgment by the auditor in assessing estimates and judgements made by the directors.
- 3.5 Secondly, the auditor is assessing whether the financial statements are a true and fair reflection of the company's performance but this does not provide any guarantee as to the future financial wellbeing or performance of a company. The financial statements provide information from which shareholders and other investors must assess the company's viability for themselves, based on a proper understanding of those financial statements or other financial and non-financial information provided by the company and obtained from other sources.
- 3.6 Auditors have an important role to play in ensuring that companies fairly report their financial performance, however good or poor that may be. However, an unqualified audit report should not be taken to mean that the company is necessarily a sound investment.

#### **4. Are any changes to the auditor's role desirable?**

- 4.1 In considering whether any changes to the auditor's role are desirable, it should be noted that UK auditors operate in a largely global regulatory environment – the regulation of the audit profession is prescribed by European directive, and audits are conducted in accordance with International Standards on Auditing. This international harmonisation is necessary in today's global business environment, therefore changes to the auditor's role would need international acceptance.

##### *Expectations gap*

- 4.2 We believe that the banking crisis is primarily an economic one and that auditors have generally performed well in these difficult times. However, the value of the audit may be undermined by the expectation gap that exists about the role of the auditor, despite efforts by the audit profession and standard-setters to address this issue. We support continued research by the Auditing Practices Board (APB) and others to identify ways of making audit reports more useful and informative. This could include developing more straightforward language and determining what information investors and other users would like to see in audit reports, and determining what level of assurance is required.

#### *Proportionate liability limitation*

- 4.3 A statutory limitation of liability for auditors is also an essential requirement, in order to allow auditors to improve the quality and usefulness of the audit report to users. ICAS has advocated for a long period that there should be a limit to auditors' liability. Traditionally, there has been unlimited liability, but this needs to be restricted in today's markets where auditors are exposed to huge liability claims out of all proportion to the degree of fault. A more realistic environment needs to be created where the direct financial penalties on auditors for making a mistake are significant but not so far reaching and disproportionate as to threaten the existence of the firm itself. The Companies Act 2006 allows auditors to agree contractually with a company to limit their liability, but this is not mandatory and we have not observed any significant acceptance by companies of such agreements in practice.
- 4.4 Companies need access to quality audits at a reasonable cost but there is a high risk attached to auditing multinational companies and large financial institutions, where the auditor may be exposed to very high claims compared to the profits of the auditing unit concerned. In order to promote a choice of auditors and maintain audit quality at a reasonable cost we believe it is essential that this exposure has some limit. While the Companies Act 2006 presents the option for auditors' liability to be limited, we believe that it is preferable for the legislation to be set out so that proportionate liability is applied automatically.

#### *Audit quality*

- 4.5 A common response to events such as the current banking crisis is to increase regulation – for example, to recommend that the work of a profession such as auditors should be even more tightly specified and regulated. This was seen in the USA as a consequence of the Enron scandal – highly-detailed new assurance requirements on internal controls were introduced as a direct response to the crisis. But these have already been revised to become more principles-based as it became apparent that the original requirements were more onerous than had been intended. ICAS strongly believes that audit quality is enhanced by a principles-based approach to auditing standards, which permits auditors to exercise their professional judgement, thereby allowing them to see the 'big picture', rather than focussing on compliance with detailed rules. This type of approach is essential in assisting the audit profession to work to enhance the quality and value of the audit.

#### *Evolution of auditing*

- 4.6 Further changes to the role of the auditor may evolve in response to future developments in financial reporting or changing demands from investors and other users as to what is required from the audit. The banking crisis has highlighted concerns that the financial statements of large financial institutions and other listed entities are excessively long and complex. While it must be recognised that much of this complexity in financial reporting arises from the complexity of the underlying business

structures and transactions, ICAS supports future work to address these issues by developing more principles-based financial reporting standards and investigating simpler forms of financial reporting. Changes to the auditor's role would flow from these developments, as the assurance required on different forms of information would have to be considered. A statutory proportionate liability regime will be necessary to facilitate such new forms of assurance.

January 2009

## **Memorandum from Ken Cooney**

Her Majesty the Queen hit the nail on the head when she enquired, when visiting the L.S.E in November, "Why did nobody notice it?". She was referring, of course, to the gathering storm in the world of banking and finance.

Whilst this submission may not be strictly in the required format, I write as one who, this year, will "celebrate" the 60<sup>th</sup> anniversary of joining a major clearing bank as a junior clerk in October 1949. Hopefully, what I have to say will provide some sort of back-drop to the way in which some banks have now arrived at this devastating situation.

One of the principal lessons which has immediately been learned from this debacle, in which the taxpayer has been obliged to inject billions of pounds into the banking system, with the likelihood of more to follow, is that the Clearing Banks are not in the same league as other business institutions. They are the custodians of the country's personal and commercial wealth and, as such, have a supreme duty of care to ensure that such wealth is not put at undue risk.

Much has been said about the inexcusable and, as yet, undefined losses which have been sustained, but each one represents a betrayal of trust to the many shareholders, depositors and borrowers, whose interests they were expected to safeguard and to whom, in many cases, advances should not have been made in the first place. Fortunately, so far, no depositors in British banks in the UK have suffered loss, except in terms of a drastic reduction in interests rates, which will have a severe impact on those who rely upon such income for day to day survival.

In 1949, a career in banking was way before the electronic age and all transactions were handwritten and ledgers were headed in copper-plate writing, using the bank's pen and the bank's blue/red ink. Fountain pens and ball-point pens were forbidden. The payees of all cheques were faithfully recorded and entries double checked to ensure accuracy. The banks enjoyed a reputation of seldom, if ever, making mistakes.

Contrast that with today, when errors are reported every week in the press, causing customers much inconvenience and no little anxiety. When eventually resolved, they are usually compensated with an apology, a bunch of flowers or a cheque for £50. It is cheaper to do that, than employ staff to ensure that the error is not repeated.

With handwritten ledgers, the branch manager had a daily record to show how customers were conducting their finances and was in an ideal position to assess the viability of any request for borrowing facilities. His decision on whether or not to lend was based on the established "Canons of Lending", which set out clearly the principal matters to be considered. These were followed, not only in the interest of the bank, but also of the customer who knew that full and fair consideration had been given to his application to ensure that, as far as possible, the venture stood a reasonable chance of success. Furthermore the CEOs and

General Management had all progressed through the ranks and understood fully every aspect of banking practice and culture.

In the 1950s, banks did not publicly seek to attract customers, advertising was largely unheard of. It was the prospective customer who was expected to approach the bank. That began to change towards the end of the decade, with more of the population progressing from weekly to monthly pay, and the need for bank accounts expanded. Machine book-keeping was introduced, although records continued to be double checked.

The 1960s saw the innovation of single-shot computer book-keeping. This relied upon numbers to identify accounts, rather than customers' cheques being read by staff. Payees names were no longer recorded, only the number of the cheque itself was printed on statements. The bank manager no longer had precise details of how his customers were spending their money, without referring specifically to the cheques themselves. During this decade the banks' customer bases grew dramatically, to the point where almost everyone is now obliged to have a bank or building society account to manage their personal lives.

Hitherto, banking activity had focussed principally on meeting customers' basic requirements in terms of deposit taking and advances, with executor and trustee services also on offer. The unprecedented increase in customer numbers in the 1970s and 1980s, however, encouraged banks to seek ways and means to offer additional financial services which, hitherto, had been unrelated to branch banking. These included the provision of mortgages, credit cards, insurance, payroll, investments services etc. to name but a few. Wider investment in foreign and overseas banks also developed, but not always successfully.

To maximise the potential of these new activities, branch managers and staff were actively encouraged to promote products and were rewarded by the payment of annual bonuses when targets were achieved. Perhaps unwittingly, there was a temptation for staff to concentrate more upon the short-term achievement of personal targets, rather than the specific long term benefit to customers. This was later highlighted by the subsequent and well publicised miss-selling of endowment insurance policies to support mortgages, for example.

A different culture began to emerge in the late 1980s and early 1990s when it appears that "market share" to some extent, began to supersede "customer care". The focus was on improving cost/income ratios with a view to maximising profitability, in what was developing into a global 24/7 market. UK banks could no longer claim to control the UK market and one gained the impression that, if they did not provide a given service, banks from elsewhere in the world would.

Although I was not privy to bank thinking at the time, it does not require much imagination to conclude that, if that were to happen, UK banks could lose market share, profitability and suffer a fall in share price.

As a former bank inspector and senior branch manager, I retired at the end of my career, in 1992. Around that time, some banks undertook a drastic reduction in staff, including middle and senior management. Many over age 50 were retired early and others made redundant. I returned to the bank in 1993 to join the management team in providing appropriate services to displaced staff and remained there until the unit closed in 1996. It was said at the time that such a loss of in-depth experience could result in banks effectively “losing their memories”. Little did one expect that some would “go out of their minds” a few years later.

As for the man in the street, to use the analogy of the BBC comedy Dad’s Army, the long serving and experienced Captain Mainwaring and Sergeant Wilson were no longer available for a friendly chat and advice at the bank in Warmington on Sea. They had been obliged to take early retirement and the branch was now in the hands of a well-meaning but vastly inexperienced Private Pike.

In the absence of in-depth management experience to challenge the viability of future activities, it is hardly surprising that when exotic financial instruments, including neatly packaged sub-prime mortgages began to appear, no one thought to examine them in detail. After all, they were AAA rated and therefore must be a pretty safe investment. It could, perhaps, have been embarrassing to admit to ignorance when auditing or regulating these new innovations.

The failure to verify these products thoroughly was not a fleeting error of omission, but a fundamental error of commission, with bankers, auditors, regulators and credit reference agencies ( little has been said of them) apparently totally unaware of the catastrophic risks which were being taken. Anxious not to be left out, one by one banks leapt over the precipice like lemmings.

Principally, in the mortgage market, why were 125% loan to value mortgages even considered, let alone sanctioned? Furthermore, self-certification was an invitation for some to engage in financial embroidery to achieve their desired result - and those accepting the information had personal targets to meet!

Credit Card invitations dropped through letter boxes on a daily basis and those, who earlier had considered banks to be prudent and conservative, erroneously believed that they would not have been offered such facilities, if they were not regarded as creditworthy.

All this information was in the public domain, in the press and in the media. The question which needs to be addressed as a matter of urgency is why were such patently obvious failings in the system allowed to occur? Was it because supervision now rested with three bodies, the Government, the Bank of England and the FSA, and each thought that one of the others was responsible. It is now apparent that there was no joined-up thinking in this vital area. Could they not see the wood for the trees? Did no one think to pick up the phone?

In a recent interview on BBC News, Sir Brian Pitman, the former highly respected CEO and then Chairman of Lloyds TSB said that, in his day, if the ratio of a bank's deposits to lending was not in accordance with the established formulae, the Chairman of that bank would have been summoned by the Governor of The Bank of England and politely requested to put matters in order, which he duly did. Was it so difficult for regulators at the FSA to notice that there was evidence that some banks were borrowing short and lending long?

The failure of Northern Rock, Bradley and Bingley and others has been due to a failure to address this basic principals of good lending. Throughout this whole debacle too light a touch has been displayed by some senior management, auditors and regulators. Too much has been taken on trust, too little understood about the exotic products in the market. Was the thinking that the banks had been in business effectively and efficiently since the 19<sup>th</sup> century, that they were renowned for their caution and probity and that there was really no need to probe too deeply into things which they didn't understand? It would appear so.

Above all, the priority in banking should be serving the customer's best interests, the promotion of financial services should be focussed on his or her true requirements, not the satisfaction of achieving short-term targets, without being responsible for the long term consequences. As to exotic investments, the maxim that "if something looks too good to be true, it probably is" could not be more relevant today. Banks enjoy the unique privilege of being the custodians of the country's wealth, but it will take some time before they regain the respect which their predecessors strove with pride over previous decades to maintain. How many more skeletons have yet to be revealed, I wonder?

The whole industry requires root and branch revision. Climate change has hit the banks with a vengeance. The rivers of liquidity in the markets have dried up and will take some time to flow again. With funds in short supply, one questions the validity of asking the population to spend more, when their own personal liquidity, jobs and even homes could be under threat in the months to come.

In the short term, some spending might provide a breathing space for businesses to adjust to the new and more challenging years ahead. In the longer term, however, the emphasis should be on encouraging people to save and to build up their own personal reserves. Another bombshell, which is now coming more into focus, is the inadequacy of pension provision. Personal saving is essential and should be encouraged more by the State, in a variety of ways. If that fails, funding will have to be found through increased taxation and that could be political suicide. The re-introduction of MIRAS up to a certain limit, for example, might assist the first time buyer into the housing market, in the present climate.

The unlimited access to unsustainable personal borrowing, however, must surely be examined carefully. It will take decades to clear the £1.5 trillion of personal debt already in the system and that will be difficult. In the 21<sup>st</sup> century, I would not expect the UK to return to the financial climate of 50/60 years ago. At that time, as a bank clerk, it was forbidden to take on any debt, except for house purchase. When I bought my first Morris Minor in 1958, it had taken years to save

the £500 purchase price. On a salary of only £500 p.a. it was hard work, but it was worth while and most of all, it taught me to respect the value of money. Too little education is given to the public on managing personal finance and too many are unaware of the pitfalls. Money, or lack of it, plays a huge part in all our lives and there is no excuse for such widespread ignorance on this subject in the 21<sup>st</sup> century.

If you have read thus far, thank you. I trust that the above comments will give some historical background to banking over the last half century, or so, and I wish the Select Committee well in their future endeavours to restore some sanity into banking in the UK.

*5 January 2009*

## **Memorandum from Resources Compliance**

### **NOTE**

*In responding to the call for evidence issued by the Treasury Committee of the UK Parliament, we have confined our comments to those areas in which Resources Compliance has the appropriate expertise and experience. We have not considered or commented directly upon those areas of the Treasury Committee's Call for Evidence that we feel are outside of our experience or competence.*

### **1. EXECUTIVE SUMMARY**

We have summarised our key conclusions below.

- 1.1 If properly implemented, More Principles Based Regulation (MPBR) can work more effectively than highly prescriptive regulation (and has the potential to provide an effective basis for rebuilding trust and confidence in the financial system).
- 1.2 Regulators and senior managers in the financial services sector need to buy into the key concepts of Governance, Risk and Compliance (GRC) as three pillars of an effective cultural framework.
- 1.3 The existing regulatory system in the UK and Europe provides the necessary tools and structures for effective regulation.
- 1.4 National regulators must make better use of existing regulatory powers.
- 1.5 National regulators must better co-ordinate in enforcement of existing regulatory powers.
- 1.6 The remuneration culture in leading investment banks is not consistent with prudent risk management and must change.
- 1.7 The UK regulatory system needs to find more effective ways than, for example, the approved persons regime, of ensuring that senior managers of financial institutions are accountable for risk taking, how they treat customers and instances of failure.
- 1.8 Stakeholder responsibility and engagement, including the definition of 'bottom line' fiduciary responsibility, needs to be redrawn and understood in a wider ethical framework.

### **2. FINANCIAL STABILITY**

#### **2.1 Business and Regulatory Culture**

2.1.1 The move to Principles Based Regulation (PBR) has been an evolutionary process, starting from 2002, when FSA issued Discussion Paper 18.<sup>22</sup> Since its adoption in May 2007 as the major regulatory methodology, it is evident that many senior managers in banks and investment firms have failed to grasp the key obligation to identify and control risks. MPBR used effectively should direct attention of senior managers and regulators towards the important issues such as business models and exposure and away from minutiae. As FSA's own reports on Treating Customers Fairly (TCF) and MPBR show, many have made poor progress in implementing cultural and behavioural frameworks that reflect good corporate governance, appropriate risk identification and mitigation establishing compliance as an integral part of operating procedures.

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<sup>22</sup> FSA Discussion Paper 18 (DP18) entitled "An Ethical Framework for Financial Services" was authored by David Jackman and was issued by FSA in October 2002. DP18 made a strong case for the failure of prescriptive regulation and the adoption of a More Principles Based approach to regulation.

- 2.1.2 We perceive the problem is greatest in large organisations compartmentalised in a way that makes day-to-day work seem unrelated to the risks identified at senior management level and where compliance often works in 'silos'. In such cases it is difficult to achieve a culture where all staff, from the senior managers to junior staff understand that PBR requires firms to define and sustain compliant behaviour.
- 2.1.3 The MPBR approach, even if sometimes only operated half-heartedly by FSA, has not fared any worse than more traditional prescriptive based regulation as practiced in the USA. Certainly when the relative impact upon both the UK and the USA is compared, it can be argued that the highly prescriptive USA model of regulation was less flexible and less successful than the MPBR approach in the UK (and more generally in the rest of the European Union (EU) via the Financial Services Action Plan directives).
- 2.1.4 We cannot see any reasonable case for reversing the move to MPBR. We see a very strong case for greater enforcement of senior management responsibilities under MPBR, particularly in the areas of GRC.

## **2.2 Remuneration**

- 2.2.1 The issue of remuneration in financial services is inextricably linked to the issue of GRC. Governance, Risk and Compliance are the three pillars of senior management responsibility.
- 2.2.2 Clearly a bank or investment firm with a good standard of corporate governance and ethics will recognise that remuneration can reward talent but if allowed to do so can also promote reckless risk taking.
- 2.2.3 It is the case in the investment banking sector that traders are encouraged to trade the assets of the bank in search of profits. This has given rise to great innovation in the financial system and to very significant rewards and remuneration for the relevant bank employees and senior managers. We acknowledge that in objective terms the levels of salary and bonus paid in the financial services sector (and particularly in the investment banking sector) are vast and do not always reflect the profit made or the effort expended. Similarly, losses made or failure has not to date attracted any corresponding downside in remuneration.

- 2.2.4 We do not object in principle to the concept of rewarding innovation, controlled risk taking and success. However, it is clear that within the financial services sector remuneration and especially bonuses, should be structured so as to reward innovation and profit, but should be balanced by other factors including ethics, risk mitigation and compliance. The current culture of very high salaries and extremely high bonuses often leads to excessive risk taking and should be severely discouraged.
- 2.2.5 We argue that the correct medium to change the remuneration culture is via challenge to senior management within the framework of GRC. We see this being led by FSA as the industry regulator via its ARROW risk assessment process. Where remuneration can be justified and risks are acceptable we would expect there to be no difficulty with a specific remuneration structure. However, where a firm could not demonstrate that its remuneration policies took account of risk, we would expect pressure to be brought to bear by FSA for a bank or firm to review its remuneration policy.
- 2.2.6 Incentives for senior managers and traders to recklessly pursue short-term profit whilst failing to adequately control risks to their business must be prevented. Such preventative measures would preferably be via good GRC cultures within banks and investment firms. However, if no immediate progress is made towards good GRC practices, regulatory intervention could be used to enforce it.

## 2.3 Regulatory Capital

- 2.3.1 Much comment has been offered, principally in the mass media of television, radio and newspapers, relating to the cause of the Crisis. However, little serious consideration has been given to the systemic framework and the extent to which under international treaty obligations or limitations of national jurisdiction, it would have been possible for any national regulator or government to have acted in isolation to address the root causes of the Crisis.<sup>23</sup>
- 2.3.2 We observe that under the Banking Consolidation Directive and the Capital Requirements Directive (recast Capital Adequacy Directive), which implemented the Basel 2 framework, national governments and regulators can impose more severe capital and liquidity requirements on home state regulated firms, but cannot do so for firms operating under a BCD or MiFID passport.<sup>24</sup> The intention behind the directives is to achieve a level playing field and a single market for financial services within the EU and the European Economic Area (EEA).
- 2.3.4 We do not believe that the UK Government could have imposed additional capital or liquidity requirements on banks, investment firms or insurance companies to those required in the appropriate EU Directives. To do so would have risked damaging the prospects for UK banks, investment firms and insurance companies in competitive markets. It could have resulted in regulatory arbitrage, placing UK firms at a competitive disadvantage and possibly causing companies and banks to locate their headquarters in other EU jurisdictions, notably Ireland or Luxembourg.

## 2.4 Regulator Powers

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<sup>23</sup> The current financial stability framework in Europe is based around the Basel 2 framework which is now law in all EU countries. It applies to banks and to most large investment institutions. The regulatory capital requirements are set out in the Banking Consolidation Directive (BCD) and the Capital Requirements Directive (CRD). A similar provision is in the process of introduction for insurance companies. This is known as Solvency 2 and is due to be finalised in 2009 and adopted into national law in 2011.

<sup>24</sup> The calculation methodologies used under Basel 2 to assess complex risks, have been agreed by Central Banks and regulators under the auspices of the Bank for International Settlements. The Basel 2 framework sets out a three pillar approach to capital. Pillar 1 sets out minimum capital requirements based upon the activities the firm carries out. Pillar 2 involves a very detailed bespoke assessment based on operating risks, market risks, position risks and related risks carried out internally by the bank or investment firm. This is known as the Internal Capital Adequacy Assessment Process (ICAAP) and is intended to be a robust examination of the potential downside risks a firm may face and the ability of the firm to withstand them. The downside risk assessment should include modelling that tests the ability of the firm to withstand very severe market crises. The ICAAP is followed by a Supervisory Review and Evaluation Process (SREP) carried out by the firm's home state regulator. This allows the home state regulator to be satisfied that a firm or bank has adequately assessed the risks it potentially faces and has sufficient capital to continue in business. Pillar 3 of the Basel 2 framework is based around public disclosure of the risks assessed and the ability of the firm to withstand them.

- 2.4.1 Based upon the framework set out within MiFID and related Directives (e.g. the Money Laundering Directives), it is clear that adequate regulatory powers exist in all major EU states for regulators to police the financial services sector and to intervene or discipline firms who are in breach of regulations.<sup>25</sup> This power also includes the power to discipline and prosecute individuals and senior managers where required.
- 2.4.2 We observe that the willingness to enforce the regulatory framework varies from state to state and from sector to sector within the financial services market. Some jurisdictions have a better track record than others of enforcing financial regulation. (The UK has a reputation as a strong regulator in this respect.) However, the FSA is limited in its ability to police the UK financial services sector by access to appropriate resources, principally people of suitable competence in the area of assessing people risk and culture.

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<sup>25</sup> The powers of national regulators for banking and investment business in the European Union are largely derived from various EU Directives. The principal Directives are the Markets in Financial Instruments Directive (MiFID), the Banking Consolidation Directive (BCD) and the Capital Requirements Directive (CRD). MiFID and the MiFID implementing regulations set out clear guidelines and regulations relating to Governance, Risk and Compliance for banks and investment firms. These requirements are then incorporated into the rules handbooks issued by the Financial Services Authority in the UK. (Equivalent regulators in other EU states similarly incorporate the Directive requirements into their rule books.) The key components are senior management responsibility for adequate governance, for risk assessment, risk control and risk mitigation (including risks to the firm's capital adequacy) and compliance with conduct of business rules and regulations.

2.4.3 We conclude that there is no fundamental weakness in the regulatory system within Europe. However we suggest that national regulators must make better use of existing regulatory powers and must better co-ordinate between themselves in enforcement of existing regulatory powers.

## **2.5 Passports**

2.5.1 For similar reasons we do not believe the passporting regime permitted under various financial services directives of the EU played any significant role in causing, nor could it have played any significant role in preventing, the Banking Crisis. There is no evidence to suggest that large banks, investment houses and insurance companies would not have invested in the securitised debt instruments had they not been operating under cross border branch or service passports within the EEA. Indeed, the evidence suggests that many institutions based in the EEA but not operating under passports invested in such instruments (as did many institutions based in non-EU jurisdictions). There is thus no obvious link between the EU passport arrangements under the Single Market and the current Banking Crisis.

## **2.6 Regulatory Cooperation**

2.6.1 The exposure to the default on USA sub-prime loans was exported into the worldwide financial system as a result of the packaging of such debt into securitised loan obligations that were then sold to institutions and investment funds worldwide. Such instruments fell within the scope of existing national regulatory frameworks, but the extent of exposure appears to have been larger than could be monitored at national level.

2.6.2 The volume of risk relating to credit default swaps or similar instruments far exceeded the ability of any counterparty to meet the liabilities arising from any systemic failure in the market. Such transactions relied upon buyer due diligence to ensure the counterparty risk was acceptable as there is no centralised monitoring of such risk exposure.

2.6.3 The international nature of the Banking Crisis is self evident. However, given the lack of any supranational regulatory body to take such responsibility, the immediate responses to the Banking Crisis had to be handled at national regulator and national government level.

- 2.6.4 We are aware that as events in one state occurred that had an impact in another state, the relevant regulators and governments shared information to a greater or lesser degree. However, there was no standing forum in which regulators could initiate and coordinate an immediate response. What became clear was that events of a global nature could not be dealt with effectively at national level alone. The benefits of cooperation and coordination (even though somewhat ad hoc and informal) were demonstrated in the restrictions on short selling of bank, investment firms and insurance securities that were gradually implemented in most jurisdictions in September 2008. This measure effectively prevented further speculative pressure from being brought to bear on already depressed stocks.
- 2.6.5 The collapses of the magnitude of Lehman and AIG in the USA had far reaching consequences simultaneously in both national jurisdictions and international markets. Such complexity was unprecedented and demonstrated that the level and sophistication of regulatory cooperation and coordination had not kept pace with market developments. New structures and frameworks are required to expand the ability of international regulators to cooperate and coordinate their activities. We have no firm view as to how such a development should be structured. However, we point to the development of Regulatory Colleges within the EU as a possible first response that may be expanded upon.

### 3. PROTECTING CONSUMERS

- 3.1 A major concern for the public during the current crisis has been the disconnect between the level of care and fairness exhibited by the industry towards consumers, which stands in stark contrast to the care and support taxpayers are now expected to show towards the banks and other financial institutions. Unless this mismatch is addressed as part of the overall recovery package then the public will consider that they have experienced yet another raw deal.
- 3.2 FSA's own regular reports on TCF indicate a fairly dismal picture of firms' ability to understand what it means to act fairly and to embed a consumer centric culture across their organisations. In our opinion, TCF should never have been a separate initiative, but part of the FSA's mainstream regulatory practice – along with a greater emphasis on MPBR.
- 3.3 It is the intention now (stated by the FSA in November 2008) that TCF will become part of mainstream monitoring. The message is that has been received, however, is that TCF was a passing fashion and is no longer of significance to FSA.
- 3.4 Unfortunately, both the industry and the regulator seem to find it difficult to deal with people risk and soft/ethical issues which are core to the customer experience and delivering the six FSA consumer outcomes. These six outcomes are the best description we have of the kind of consumer system we wish to have in the UK and serve well as a basis for guiding the reconstruction following the current crisis. Much more effort from FSA needs to go into defining what these outcomes mean in concrete terms to help the industry understand what it needs to do practically.
- 3.5 The FSA's TCF (July 2007) culture document was a good first effort in this area but has not been supported either by further documentation or by supervision practice on the ground – or so it appears. Also the shift away from making a range of TCF visits during 2009 on the subject undermines the scariest effort to date to emphasise the importance of this cultural dimension in firm's behaviour. A firm's culture is key to controlling risk and thus also key to delivering acceptable consumer outcomes. This area requires much more attention by the regulators and legislators. We need to find more appropriate tools for assisting the industry to deal with the undeniable problem it has in addressing values issues.
- 3.6 The recent Retail Distribution Review (RDR) proposals make some headway in placing an emphasis on culture and values but the recent proposals seem compromised by industry lobbying. Once again, the principles regime ought to lead to a focus on the key problem of the

commission-based selling. If we are to rebuild trust and confidence in the sector following recent difficulties then we need to ensure that at every level there is an efficient, competent and fair system which delivers advice and services which can be trusted.

- 3.7 It is unlikely that an arms length Professional Standards Board as proposed in the RDR interim report will have sufficient teeth to deliver the scale of change that is that expected by consumers. These issues need to remain central to FSA's remit and should not be outsourced. Doing so compounds the message that the behaviour of firms need only be legal rather than finding a broader definition of what is fair.

### **RESOURCES COMPLIANCE and RESOURCES GLOBAL PROFESSIONALS**

Resources Compliance is the financial services regulatory and compliance consulting arm of Resources Global Professionals, a major international professional services firm which is listed on the NASDAQ market in the USA.

January 2009

## **Memorandum from KPMG**

The role of auditors in the banking crisis, and whether any reform to that role is desirable

### **1 The current role of the statutory auditor**

1.1 The role of a UK company statutory auditor has been well established for many years and is now clearly set out in the Companies Act 2006. In the last few decades, and in response to certain high profile corporate failures, further measures have been taken to ensure that audit quality continues to be enhanced (primarily through the establishment of an independent regulator and standard setter). The primary objective of the role itself has not, however, been altered; this remains to provide an opinion to the shareholders of a company on whether the financial statements of the company present a true and fair view. Those financial statements are not projections of the future, but based on transactions entered into during the period and relevant information generally as at the reporting date. They are therefore inevitably, as the Committee's previous report noted, "a snapshot of the past state of the company" and the audit opinion is clearly set in that context. Both the financial statements and the audit opinion do, however, provide value to shareholders and others in considering the stewardship of management and performance of the company.

1.2 The Audit Inspection Unit (AIU) of the Financial Reporting Council (FRC) recently published its reports on the major UK audit firms as well as its annual report to the Secretary of State for Business, Enterprise and Regulatory Reform. The overview of its findings in respect of the audits of economically significant entities noted that "The AIU considers the quality of auditing in the UK to be fundamentally sound. The AIU public reports indicate that the senior management of the seven major firms are committed to audit quality and have quality control procedures in place, which are appropriate to their size and nature of their client base." In considering the response of the firms to the credit crunch it further noted that "Overall, the AIU considered that the firms responded appropriately and on a timely basis to the significant challenges arising." The report rightly noted that this assessment was, in most cases, made prior to 31 December 2007, but certainly in respect of the AIU's ongoing reviews of this firm's individual audits for that reporting date we are not aware of anything that would alter this assessment.

1.3 Overall therefore there is clear evidence that the current role of the auditor is being fulfilled adequately and the question appears to be more whether any reform of that role is desirable and if so what that should be.

### **2 2008 year ends**

2.1 The major firms have continued to work with the FRC and other interested parties to ensure that the response of the auditing profession remains positive in particular in providing appropriate information to investors without provoking an overreaction. In this context we welcome the recent guidance issued by the FRC and the Auditing Practices Board (APB) on going concern considerations. It may be worth mentioning at this point that it would unlikely for a set of bank's financial statements to be issued if there was a significant doubt around going concern. The auditor has a statutory duty to report to the FSA inter alia if they believe they are likely to issue a modified audit report. We have had indications from the FSA that this would in itself be sufficient for them to crystallise the bank's status either by ensuring support is provided or suspending its licence to take deposits. In both cases this would affect the financial statements that were about to be issued.

### **3 Possible other roles for the auditor**

3.1 At the outset we would note that we believe that it is essential for any changes to take proper account of the global context in which most major organisations operate. In many ways the accountancy profession has a significant advantage in having credible international standard setters for both accounting and auditing. Both of these have had significant input from the UK profession and the goal must be for them to gain ever increasing acceptance across the world, not for the UK to take unilateral action in response to what is clearly a global economic crisis.

### **4 Review of controls**

4.1 It has been suggested by some commentators that the role of the auditor should be extended to providing assurance on controls along the same lines as the Sarbanes-Oxley requirements in the US. The US requirements, however, only extend to assessing controls over financial reporting, not wider business controls; they are not therefore directly relevant to the current crisis. Even with this restricted scope this blanket approach has been subject to criticism by some and we believe the cost and benefits of any such proposal would require further study before being implemented. We would, however, be supportive of such a study - possibly at an EU level.

### **5 Reviews of risk management processes**

5.1 The Committee's earlier report recommended that further consideration be given to what further assurance auditors might provide to shareholders in respect of the risk management processes of a company.

5.2 At the outset we would note that we firmly believe that the Board and management must have the initial responsibility for providing such information to shareholders and other stakeholders. Some of this type of information pertaining to the management of financial instruments is required by IFRS7 (which was first implemented for December 2007 year ends) and this is indeed audited. Provided any further requirements are clear (and this may involve

extending the current business review requirements in this area), it might be possible for auditors to provide some specific comfort on management's disclosures. To the extent that such information and assurance might be regarded as predictive in nature however suitable safe harbour protections would be required for both directors and auditors; neither is in the business of forecasting the future. We would also caution against raising false expectations of what such assurance might provide. We doubt for example whether it would highlight to any greater degree the risks to any business model of an event that no-one envisaged would happen. The cost/benefit analysis of such extra disclosure and audit work must therefore be properly evaluated.

## **6 Further support for the regulatory process**

6.1 More importantly, however, we believe that auditors have in the past played a more valuable role with some of the financial services regulators. Specifically in the 1980's the auditor's role tended to be better defined (although varying somewhat between regulators) and the regulators used the auditors on a regular basis in support of the regulatory process. By and large we believe this had positive effect on the financial services industry, the effectiveness of the regulatory process and the audit itself. Since the formation of the FSA this was replaced by a much more ad hoc regime which we do not believe has generally contributed much to the regulatory process. We would welcome the interaction between regulator and auditor being reinvigorated as we believe when the auditors are used proportionately in support of the regulators that it is cost effective, provides other indirect benefits to the institutions themselves and deepens the auditor's understanding of the business so enhancing audit quality.

January 2009

## Memorandum from Mr James Robertson

### Author's Background Note

1953-65 Whitehall official.

1960 accompanied Prime Minister Harold Macmillan on his African tour (introduced 'wind of change' theme into PM's speeches).

1960-63 Cabinet Office.

1968-73 set up and directed the UK Inter-Bank Research Organisation.

1968-71 House of Commons Procedure Committee - part-time Adviser on parliamentary control of public spending and taxation.

1973- Independent writer, lecturer, consultant.

1984 co-founded the New Economics Foundation, London.

2000 co-authored *Creating New Money: A monetary reform for the Information Age*.

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### I. EXECUTIVE SUMMARY

1. This evidence is on the Committee's point 1.8, *amended as follows*:

"Possible improvements to the architecture of (*national and*) international financial regulation, and maintenance of (*national and*) global financial stability".

It affects other points too, as will be clear.

2. The money used by national and international monetary and financial systems provides the foundation for their architecture. Who creates and issues the money supply, and in what form, affects how those systems work and therefore how they should be regulated.

3. The ways money is now created, both for national and for international economies, combines conflicting functions. That is a cause of recurrent financial crises, and of other economically, socially and environmentally damaging outcomes. New, updated ways of creating national and international money supplies would separate the conflicting functions. Ideally, further emergency measures to deal with the current crisis would provide stepping stones towards those simpler, more basic changes.

4. The first proposal is for genuine nationalisation of the national money supply, making it unnecessary to nationalise commercial banks.

5. At present less than 5% of the estimated UK national money supply is created and issued as banknotes and coins by agencies of the state. Almost all the remaining 95% is created and put into circulation by commercial banks and building societies as profit-making loans in the form of bank-account money (often called "credit"). The Bank of England can only try to influence the amount the banks create by regulating interest rates. The proposal is that the Bank of England should itself create and issue bank-account money debt-free, and that - as already with banknotes and coins - nobody else should be allowed to create it.

6. The second proposal is for genuine internationalisation of the international money supply. In other words, the UK government should be asked to consider promoting the introduction of a genuinely international currency. It has now become unrealistic to hope that the US dollar or any small group of competing national or regional currencies like the dollar, euro, yen, yuan, rouble or pound can provide a firm foundation for a stable, efficient and fair international economy in a globalised world. Combining that underlying weakness with continuing to rely on money largely created as private sector debt, makes the international economy doubly vulnerable to instability (see para 35).

7. It is desirable (see para 33) for governments to discuss internationally the first, as well as the second, of these proposals. The Select Committee might therefore suggest that, as host to the G20 meeting in London on 2nd April 2009, the UK government might place the two proposals on the agenda for preliminary discussion. In the past two centuries distinguished leaders in the United States as well as in the UK have supported the first proposal, for a genuinely nationalised national money supply. The second proposal, to introduce a new genuinely international currency alongside national ones, shares the underlying principle of Keynes' proposal at the Bretton Woods Conference in 1944, and the principles put forward by the Independent UN International Commission on Global Governance in 1995. It has recent support from the BRICs Group of countries (see para 38).

8. Some experts in the complexities of existing financial architecture may dismiss these proposals as too radical and simple. But measures unthinkable a few months ago have now been taken in response to the present crisis. So I hope the Select Committee will ask the government to study these commonsense proposals and not dismiss them out of hand. They are in tune with the UK's historic record of financial evolution in response to changing needs. Treating them seriously could increase the Committee's credibility at a time when people are looking for new solutions to the problems of the new financial world of today and tomorrow.

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## II. INTRODUCTION

9. The Committee has asked for evidence on thirty points in the key areas of (1) securing financial stability, (2) protecting the taxpayer, (3) protecting consumers, and (4) protecting shareholder interests. This evidence is on the Committee's point 1.8, *amended as follows*:

Possible improvements to the architecture of (*national and*) international financial regulation, and maintenance of (*national and*) global financial stability.

It affects other points too, as will be clear.

10. Effective changes in organisational architecture have to have a stable foundation. On reforming the obsolete structures of British government in the

early 20th century, an outstanding administrator of that time, Sir Robert Morant, warned against "seeking to build a substantial house by working spasmodically on odd portions of the structure on quite isolated plans, fashioning minute details of some upper parts, when he has not set up, nor indeed even planned out, the substructure which is their sole foundation and stay: his very best efforts being rendered abortive by the fact that, while he is hammering at this portion of it or that, he possesses no clearly thought out plan of the structure as a whole".

11. Money is the foundation of national and international monetary and financial systems. How the supply of money is created and issued, who by, and in what form (as debt or debt-free, in one currency or another), goes far to determine whether a money system is stable. If money continues to be supplied for national economies and the international economy as it is today, they will inevitably continue to suffer damaging crises of financial instability.

### **III. NATIONAL FINANCIAL ARCHTECTURE**

12. The public money supply is at present created as follows. Less than 5% of the estimated UK national money supply is created and issued as banknotes and coins by agencies of the state. Most of the remaining 95% is created and put into circulation by commercial banks and building societies as loans to their customers in the form of bank-account money (still often called "credit", as if distinct from money). If that were not the status quo and we were starting from scratch, nobody would seriously suggest that the same businesses and procedures should combine the two conflicting functions - putting 95% of the public money supply into circulation efficiently and fairly on behalf of society as a whole, and competing for profit in the market for lending and borrowing. It would be obvious that to mix them up together would reduce the efficiency and reliability of both functions.

13. The facts show that, in practice, crises of financial stability do inevitably result from combining them. This was famously expressed from the commercial bankers' point of view by the outgoing Chief Executive Officer of Citibank in 2007. Shortly before receiving his \$multi-million 'golden parachute' to compensate for being 'chucked out' of his crisis-stricken bank, Chuck Prince explained that, "As long as the music is playing, you've got to get up and dance". As director of Inter-Bank Research during the secondary banking crisis of the 1970s, I saw and understood very well why, once the herd starts stampeding toward the abyss, bankers decide it's better to be wrong with the herd than right but alone outside it.

#### **Separating The Two Functions**

14. A basic monetary reform consisting of two complementary measures is needed to separate the two functions.

(1) It will transfer to nationalised central banks like the Bank of England the responsibility for creating, not just banknotes as now, but also the major

component of the supply of public money that consists of bank-account money mainly held and transmitted electronically.

(2) It will prohibit anyone else, including commercial banks, from creating bank account money out of thin air - just as forging metal coins and counterfeiting paper banknotes are criminal offences.

15. These complementary measures will fully nationalise the national money supply but not the commercial banks. After the reform, when the present crisis is stabilised, the commercial banks that have been nationalised should be denationalised, and compete freely in the profit-making market for borrowing and lending already existing money.

16. The first of the two measures will make an agency of the public responsible for directly creating and maintaining the public money supply in the public interest. The second will lead to a more competitive market for facilitating loans between lenders and borrowers than today. Losing their present privilege of creating the money they lend will bring the commercial banks into line with ordinary private-sector businesses that are not given their main materials as a free gift. It will encourage them to provide more services to customers more efficiently than now, and also make it easier to attract new entrants into the payment services industry.

### **Nationalising the Money Supply**

17. Transferring responsibility for creating all new bank-account money to the central bank will catch up with what happened to banknotes under the Bank Charter Act of 1844. That Act finally recognised that, having originated as notes of credit from private banks and merchants, and having developed into means of payment over several centuries, banknotes had turned into money. Consequently, it transferred the right to issue them to the Bank of England. So, similarly today everyone knows that the balances in our current bank accounts ("sight deposits") are no longer just "credit" but are money instantly available for spending just as banknotes are. Their total value is included in the "broad money" component of the money supply in the official statistics. (The actual total is not precisely known because of how it has been created by the commercial banks. That is one reason why, from beginning to end, nobody has known how many billions of money have been "lost" in the credit boom and bust, or where they came from and where they went.)

18. The proposal is that the operationally independent central bank should continue to implement monetary policy objectives published by the elected government. But it will no longer implement them indirectly by managing interest rates to influence the amount of new money created by banks as loans. It will itself decide at intervals how much new money needs to be added to the money supply, create it and transmit it as public revenue to the government. The government will then put it into circulation by spending it on public purposes along with other public revenue, as decided through normal parliamentary budgeting procedures. Only in exceptional monetary crises like the current one,

which will then arise less often, will the central bank play a part in deciding how the money is to be spent that it creates to meet monetary policy objectives.

### **The Money Supply after Monetary Reform**

19. After the start date for monetary reform has prohibited all but the central bank from creating new money, the money supply will change its character. As new debt-free money is created by the central bank, and as the repayment of existing bank loans extinguishes the money created by the commercial banks, the money supply will transform itself into a clearly defined and calculable fund of officially created and officially recognised money - which could perhaps be defined as "legal tender".

20. This will be money consisting of customers' "sight deposits" in current accounts with banks and other agencies licensed to manage them by the central bank, together with the money in those banks' current accounts with the central bank. That will constitute the clearly defined total supply of actual money in circulation which is immediately available for spending - a figure that will be precisely identifiable in the official statistics.

21. This fund of actual money will be quite distinct from other financial claims, such as savings accounts. Those will have been bought by their holders with money paid to their sellers. They will be recognised not to contain money themselves, but to be financial claims entitling their holders to be paid money at certain times under certain circumstances. That will be true of all other savings, investments, securities, insurance policies, etc, etc. Some will eventually pay out specified amounts of actual money. Others, like share certificates, will be exchangeable for money in the market at the going rate. In either case, a transfer of money will take place in exchange for the claim, just like the buying and selling of anything else. This will apply to purchasing or investing in other currencies - purchasers and investors will pay for them with money from the national money supply.

### **Lending and Borrowing after Monetary Reform**

22. As borrowers pay off bank loans borrowed before the reform came into force, any new money available for lending and borrowing will have been created by the central bank, and given to the government to spend into circulation. It will have circulated to, among others, people and organisations that want to lend it. Commercial banks will then channel it from them to borrowers, not creating new money but as intermediaries for transmitting already existing money from lenders to borrowers.

23. Prospective lenders, including customers of the lending bank with sight deposits in current accounts, will pay the money they lend to the bank as the purchase price of a claim to receive it back at a specified date with a specified rate of interest paid at specified intervals. The principle will, as always, be that money in the circulating fund of national money cannot be simultaneously available to more than one bank-account holder for immediate spending. The

fund of national money in circulation will remain constant except for increases or withdrawals<sup>26</sup> made by the central bank to achieve monetary policy objectives.

24. A new problem of stock control will arise for the banks, which have hitherto been able to create money as soon as their customers ask to borrow it. This problem will be similar to, though very much simpler than, the problems of stock control faced by other businesses: how to make a range of supplies available to meet customer demand, while avoiding the cost of having too much on hand for too long. It will no doubt encourage money markets to develop ways of finding existing money quickly to lend to retail banks so that they can lend it quickly to their customers. But it will almost certainly lead to some loss of flexibility for banks and their customers, which will slow down the circulation of money, so that the central bank will have to increase the money supply to provide for that.

### **Could the Central Bank Create Enough Money for Borrowing?**

25. It has, in fact, been suggested that, if the central bank were responsible for creating the whole money supply, it would not create enough to meet the legitimate needs of borrowers. But central bankers will be able to judge how long, in the circumstances of the time, it will take the money they create to circulate to people and organisations wanting to lend it, and then to adjust the amount they create to take account of that. Central bankers surely will not do worse in this respect than commercial bankers who, in the recent credit boom and bust, created far too much money in the boom and are now creating much too little in the bust. In fact, commentators are now recognising that, when we rely on commercial banks to create the money supply, the only lever available to the central bank to increase it - lowering interest rates - won't work when it is most needed and the central bank has already brought interest rates down towards zero. Currently the Bank of England is reported to be considering alternative ways to create new money and inject it directly into the economy.

26. It has also been suggested that, on the starting date for monetary reform when banks are prohibited from creating money as debt, new money created by the central bank will not have had time to circulate through public spending to people and organisations that want to lend it, and a temporary shortage of loan finance will result. But the central bank and the government should be able to resolve that problem, either by setting the central bank's starting date for the new arrangement a month in advance of that for the commercial banks, or by the central government advancing some of its public spending similarly. The details could be settled in the preparatory run up to the reform.

### **Supervision and Guarantees (Relevant to the Committee's point 1.4)**

27. Responsibilities for supervision and guarantees will be clarified by the reform. They will reflect the split between the conflicting functions of public

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<sup>26</sup> On any occasion when the central bank decided that the money supply should be reduced, not increased, the government would pay the required reduction to the central bank out of public revenue, and the central bank would destroy it.

service provision of the national money supply and the private sector provision of competitive borrowing and lending facilities as a profit-making business; and the corresponding split between the circulating fund of money constituting the money supply and the range of financial claims which are bought and sold for money but are not money themselves.

28. The central bank should have supervisory responsibility for banks (and other organisations) licensed to provide payments services in the national currency. It should guarantee all deposits in current accounts, making up the total national money supply. It should also be responsible for guaranteeing the value of financial claims, like National Savings, sold by agencies of the government, and it should therefore be responsible for supervising their administration, as well as supervising the licensed providers of payments services.

29. The Financial Services Agency should be responsible for supervising businesses dealing in borrowing and lending and other ways of buying and selling financial claims - savings, investments, insurance policies, currency exchange, etc - primarily in order to protect their customers and preserve the integrity of the actual money supply. These businesses will be handling money as buyers and sellers of financial claims, as all businesses handle money to buy and sell things. But the claims they buy and sell will not themselves be money or contain it. So no guarantees from public funds need be given to their contractual or estimated values. Buyers should buy them at their own risk, subject to consumer protection law. One important part of the supervisory task will be to ensure that existing consumer protection law is adequate. Another will be to ensure that businesses under supervision do not fraudulently try to create actual money. For that purpose both the FSA and the Bank of England will need to develop accounting and audit trails of actual money in circulation.

### **A Loss of Flexibility and Increased Cost of Payments Services?**

30. Any resulting loss of flexibility for retail banks and their customers from changing the present method of creating new money will have to be weighed against the damaging effects and serious disadvantages of continuing to allow private sector creation of new money to lend. Those include recurrent credit booms and busts - that need not otherwise be inevitable - in addition to a range of other seriously damaging and costly economic distortions and injustices.

31. Initially, losing the subsidy they now enjoy from being allowed to create money to lend may lead existing commercial banks to charge more for managing the payments systems they offer to their customers. That is always likely to be the immediate response of any industry that stops being subsidised. In the longer run, their charges are likely to be under fiercer competition from new entrants into the payments services industry. Moreover their customers will no longer be bearing the costs imposed on every user of money when almost all the money in circulation has been created as interest-bearing debt.

### **International Competition**

32. Some say that the proposed monetary reform would be damaging to the UK economy: being deprived of their present subsidy would put UK banks at a competitive disadvantage against competitors from other countries, and "would lead to the migration from the City of London of the largest collection of banks in the world"<sup>27</sup>. Until the credit boom turned to bust, the financial sector energetically publicised its contribution to national GDP. Economic commentators now suggest that its dominance has been a disadvantage to our economy. The government might usefully commission a comparative cost/benefit analysis of its contribution to and influence on the UK economy.

33. The present monetary and financial crisis is recognised by the UK government as requiring internationally co-ordinated responses. A similar internal monetary reform to that proposed here has been prepared for introduction in the US Congress<sup>28</sup>, and is relevant elsewhere too. The UK government might perhaps float the possibility of simultaneously<sup>29</sup> introducing monetary reform in a group of economically important countries - for example at the April G20 meeting in London.

#### **IV. INTERNATIONAL FINANCIAL ARCHITECTURE<sup>30</sup>**

34. It is time to consider seriously whether the currency on which the international monetary system is founded should be more genuinely international - as Keynes proposed at Bretton Woods in 1944. This proposal is also one that could usefully be raised by the UK government in the April G 20 meeting in London.

35. By 1995 the Independent Commission on Global Governance was saying the international monetary system should be more genuinely international and less dependent on private capital markets: "the US has had the unique luxury of being able to borrow in its own currency abroad and then devalue its repayment obligations", and "the international monetary system's dependence on private capital markets exposes it to the risk of a collapse of confidence in the system as a whole".<sup>31</sup>

36. Since then the dollar's dominance has been increasingly criticised. By 2002 the world was estimated to be paying the US well over \$400bn a year for using the dollar as the main global currency. A Pentagon spokesman justified this as a fee to the US global policeman for maintaining world order. Critics have seen it as the US making poorer countries pay for its over-consumption of global resources. World trade was being described as "a game in which only the US can produce dollars, while everyone else produces things for dollars to buy".

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<sup>27</sup> *Monetary Reform - Making it Happen*, p41

<http://www.jamesrobertson.com/books.htm> - monetary

<sup>28</sup> American Monetary Institute, <http://www.monetary.org/>

<sup>29</sup> International Simultaneous Policy Organisation, <http://www.simpol.org/>

<sup>30</sup> The need to develop international taxation and public spending is not discussed here.

<sup>31</sup> *Our Global Neighbourhood*, Oxford University Press, 1995, pp 181, 183.

37. More recently practical threats to the dollar's international position have grown. Iran has threatened to switch its oil trading into euros. Russia's President, Dmitri Medvedev, announced in February 2008 that the rouble will become a regional reserve currency; and hoped that the new St Petersburg commodity exchange would reach 1.5 trillion roubles in 2008. It was suggested that, if China eventually replaced the US as the world's main superpower, the yuan would replace the dollar as the world's dominant international currency.

38. In 2007/8 the BRICs group of countries - Brazil, Russia, India and China - and other 'emerging' countries have been flexing their muscles. India and China caused the collapse of the recent seven-year world trade negotiations in Geneva, to protect their peasant populations. In May 2008, ministers from India and other BRICs countries demanded an international monetary system founded on the rule of law and multilateral diplomacy in "a more democratic, fair and stable world where emerging markets have a greater role and the dominant powers are contained by the same rules as everybody else."

39. Failing a constructive response, international monetary chaos could follow further decline of the dollar's supremacy and the present global banking crisis. The world's people, and the world's businesses, could find ourselves in a disorganised global economy dependent on private sector investment in a variety of competing 'reserve' currencies including the dollar, the euro, the yen, yuan, rouble and pound.

40. The proposal is to promote the establishment of a genuinely international debt-free currency, used in parallel to national and regional currencies, to provide a more efficient and more stable basis for international exchanges in the global economy.

41. The new currency would be issued by a world monetary authority, with operational independence to implement the monetary objectives published by the United Nations and accountable to it. It would issue the new currency as a new source of public revenue for UN expenditure on global public purposes - peace-keeping, for example, and climate change - and possibly also for *per capita* distribution to UN member nations.

## **V. CONCLUSION**

42. If the principles of the proposals offered here to the Select Committee are thought worthy of serious consideration, the practical details will have to be explored by the authorities. But I believe they identify essential lessons to be learned from the current banking and economic crisis and the measures being taken to deal with it; and that, if they are not learned, such crises will inevitably recur.

January 2009

## **Memorandum from Save Our Savings (“SOS”) a group of charitable creditors of Kaupthing Singer Friedlander Limited (In Administration)**

### **Introduction**

This paper responds to an invitation for the submission of written evidence in connection with the Treasury Committee’s inquiry into the banking crisis and calls for evidence.

SOS is a group of creditors in the administration of Kaupthing Singer & Friedlander Limited (KSF) comprised of some 30 charities with a combined liability in the administration of approximately £50 million.

This paper addresses the following issues raised in the terms of reference: -

#### **1. Securing financial stability**

1.2 The role and regulation of credit ratings agencies in the banking crisis, and whether any reform are desirable.

1.4 Ongoing reforms to the operation of the Tripartite Committee, and cooperation between the relevant public sector authorities.

1.13 The role of the banking system within the overall economy.

#### **2. Protecting the taxpayer**

2.1 The advantages and disadvantages of the UK Government’s response to the banking crisis, including comparisons with alternative approaches adopted in other jurisdictions.

2.2 The nationalisation of Northern Rock plc and Bradford & Bingley plc.

2.3 The Government’s recapitalisation programme, and part nationalisation of major high-street banks.

#### **3. Protecting Consumers**

3.6 The impact of deposit protection on both consumers and competition.

3.8 The impact of the banking crisis on consumer confidence in financial institutions.

### **Executive Summary**

The charities within the SOS group represent a broad spectrum of charitable causes and represent a large number of beneficiaries and other stake holders such as members, supporters, volunteers and donors.

Charities, of course, enjoy certain statutory exemptions from taxation on the basis that they provide public benefit in the form of support and services to many of the most vulnerable elements of society and thereby relieve the Exchequer and, by extension, the taxpayer of the cost of providing such services.

In its Treasury-led review into the role of the voluntary sector in public service delivery, the Strategy Units Report “Private Action, Public Benefit” identified the “vital role” that charities play both in society and in the economy generally. I mention this simply by way of background and because the Committee’s terms of reference refer to protecting the taxpayer but, of course, charities are also obliged to place funds with banks and are consumers for the purposes of the Financial Services and Markets Act 2000.

A few charities within the group are still trying to ascertain whether they are eligible for compensation under the Financial Services Compensation Scheme (FSCS) but the majority of the charities within the group are not eligible under the Scheme’s rules and are therefore classified as wholesale depositors.

The distinction between wholesale and retail depositors appears to be based largely upon an assumption that wholesale depositors are better placed to make informed decisions about which firms to do business with and which not and are therefore less in need of the FSA’s protection than the “less sophisticated” retail depositors. Protection under the FSCS therefore extends to individuals and smaller companies only. The logic of this approach has, in our view, been called into question during the current crisis in a number of ways:

### **Key points**

It is difficult to see that wholesale depositors, and charities in particular, were better placed than retail depositors to anticipate and respond to the banking crisis. In this respect: -

### **Credit ratings**

In its Financial Stability Report of October 2008 (“the Bank’s Report”) the Bank of England (“the Bank”) explains the causes of a decline in the quality of credit risk assessment within the banking system and a consequent loss of confidence in credit rating methodologies.

The ratings issued by the main credit rating agencies were relatively high for KSF up until the afternoon of the 30 September which was some 5 working days prior to the FSA obtaining an Order on the 8 October 2008 placing KSF into administration.

We feel that there should be an inquiry led by the FSA into how credit ratings agencies continued to give KSF high credit ratings until just days before KSF was

placed in administration by the FSA. We would certainly argue that reforms are desirable.

It appears that the UK is behind other member states in Europe on this issue and that legislation is planned. That would appear to be an admission that current arrangements are in need of change

### **Anticipating and responding to the crisis**

In the Bank's report, the Bank explains that its April 2008 report set out 2 possible paths ahead for the financial system but concedes that it "*did not anticipate acute financial distress*". It is a matter of public record that the Bank has admitted that it did not foresee the severity of the banking crisis. How could charities have anticipated and responded to the crisis?

KSF is a UK bank regulated by the FSA. The Banking (Special Provisions) Act 2008 was passed on the 21 February 2008 and the Treasury exercised its powers under that Act for the first time on that date to nationalise Northern Rock plc.

Powers under the Act were again invoked to facilitate the nationalisation of Bradford & Bingley plc on the 29 September 2008. Neither Northern Rock nor Bradford & Bingley were put into administration.

On the 8 October 2008 the Treasury invoked its powers under the Banking (Special Provisions) Act 2008 to obtain a Transfer Order in respect of KSF. The Order clearly anticipates KSF being put into administration by the FSA on the 8 October 2008.

The events which appear to have triggered intervention by the Treasury and action by the FSA in respect of KSF appear to have had their origins in the nationalisation of Glitnir hf on the 29 September 2008 and the intervention by the Icelandic Government in the affairs of Landsbanki on the 7 October 2008.

On the 6 October 2008 the Icelandic government made a loan of c£400m to Kaupthing hf (KSF's Icelandic parent). The Icelandic's government did not intervene in Kaupthing hf's affairs until after KSF was put into administration and the Icelandic government argues that the actions of HM Treasury and the FSA precipitated its intervention.

On the 7 October 2008 Heritable (a UK subsidiary of Landsbanki) was put into administration by the FSA, the date on which Landsbanki was taken over by the Icelandic government. The freezing order in respect of Landsbanki's UK assets was obtained by the Treasury under the Anti Terrorism, Crime and Security Act 2001, on the 8 October.

It is apparent that the Tripartite authorities were reacting to events in Iceland as they happened. It is not clear how or why organisations, such as charities,

with wholesale deposits in KSF were in a better position than, supposedly, less sophisticated retail depositors to anticipate and respond to what were clearly unprecedented and extraordinary events which were played out within the matter of a few days.

### **Protecting taxpayers and consumers is concerned**

It is apparent that the steps taken to nationalise Northern Rock plc and Bradford & Bingley plc were aimed at protecting both retail and wholesale depositors. It is evident from HM Treasury's Winter Supplementary Estimate 2008-09 that guarantee arrangements in respect of wholesale deposits in Northern Rock plc are anticipated. Wholesale liabilities of Bradford & Bingley plc were taken into public ownership through transfer to HM Treasury. By contrast the Order obtained by HM Treasury under the Banking (Special Provisions) Act 2008 in respect of KSF provides protection and continuity of business for retail depositors only

The steps taken by the Government to protect retail depositors are, of course, laudable but it is apparent that the FSCS, which provided a limit on compensation of £35,000 in respect of retail deposits, was inadequate. The level of compensation was first raised to £50,000 and the Government subsequently provided a 100% deposit guarantee to retail depositors not only with the UK banks, Heritable and KSF, but also extended this to retail depositors in the Icelandic bank Landsbanki and its on-line savings provider, Icesave.

The Government contributed £2bn to an IMF loan. The terms of credit are not known but by the 17 November it was reported that Iceland agreed to refund Landsbanki/Icesave's UK investors in order to gain access to the loan.

No corresponding extraordinary measures were taken to protect the wholesale depositors of KSF such as charities, indeed no steps were taken at all. The government has said that extraordinary events require extraordinary measures but excludes wholesale depositors from these on the fragile basis that they were better placed than retail depositors to make informed decisions as to which bank to place deposits.

The Bank's report explains that a number of countries took measures to stabilise banks and their retail, and in some cases, wholesale funding by increasing the value of insured retail deposits or by announcing guarantees on wholesale funding. Deposit insurance has been resisted in the UK but what has become apparent in the current banking crisis is that the position of wholesale depositors has been exposed as totally vulnerable to events beyond their anticipation or control. This is unlikely to promote confidence in the banking system.

Because of market conditions prudent charities, such as those within the group, are obliged to place cash mostly left or given by members of the public in

the banking system. In many cases, this money represents reserves set aside for future projects of public benefit. Placing cash reserves in a bank would not, in the ordinary scheme of things, be regarded or foreseen as a high risk element of an investment strategy and so, in our view, the rather fragile distinction between retail and wholesale depositors in respect of this type of investment is even finer.

Under UK Insolvency Law, wholesale depositors, such as charities, rank as unsecured creditors and have been left to take their chances in what appears to be an unprecedented, complex and potentially lengthy administration in which, bizarrely, the single largest creditor is the FSCS which was intended to be financed by levies on FSA authorised firms.

The recapitalisation and part nationalisation of major high-street banks will protect both retail and wholesale depositors with these institutions. The anticipated funding, according to the Bank's report is likely to be in the region of £50bn. The liability to charities in the administration is in the region of £50m.

## **Conclusion**

The banking crisis has been the first major test for both the Tripartite regulatory system established in 1997 and of the FSCS established in 2001 and we would certainly argue that whilst certain aspects of crisis management by the regulatory bodies have been effective and laudable, deficiencies and inconsistencies have, in our view, been highlighted and we would argue that there have been extreme inconsistencies in the way that retail and wholesale depositors (especially charities) have been treated. The basis upon which retail and wholesale depositors have been treated differently during this crisis does not, in our view, really stand logical scrutiny given the extraordinary events and circumstances of this crisis.

We feel that the regulatory safeguards in place prior to the crisis have been shown to be deficient. The FSCS was clearly not adequate. The credit rating system is to be the subject of legislation. The Banking Bill, which was laid before Parliament on the 7 October 2008, appears to concede that Corporate Insolvency Law is unhelpful to the authorities in trying to save a failing bank and could actually put financial stability at risk.

The Banking (Special Provisions) Act 2008 (which was an emergency measure introduced to save Northern Rock) clearly has limitations and it's difficult to see that, at the time it was passed, the present crisis was anticipated. Charities could not possibly be expected to have anticipated that the Act would have been used in KSF's case.

The overall impression is that no one anticipated the severity of the banking crisis and that even the tripartite authorities had to react to unprecedented international events as they unfolded. Against that backdrop and given the apparent deficiencies referred to, the exclusion of charities from compensation

on the basis that they were in a better position to informed decisions does seem extraordinary.

January 2009

## **Memorandum from Christian Aid and ActionAid**

### **Executive summary**

Christian Aid works in nearly 50 countries worldwide, supporting local organisations to deliver urgently needed services directly to people living in poverty, and to scrutinise and hold their own governments and the international community to account. We have carried out policy analysis on issues of international finance and development for many years.

Founded as a British charity in 1972 with a mission to eradicate global poverty, ActionAid is an international NGO working in fifty countries worldwide, and our positions and recommendations reflect the experiences of our staff and partners in Africa, Asia, the Americas and Europe. In 2003 we became ActionAid International and moved our global headquarters from the UK to South Africa. ActionAid's rights based approach, which looks at the systemic causes of poverty, forms the foundation for our work on development finance.

Our submission will focus on the causes of the financial crisis. We argue that the crisis is a direct result of international financial and economic integration running far ahead of the capacity of national regulators, and of their coordination. This has been exploited by banks and other companies, as well as by secrecy jurisdictions (tax havens), for short-term benefit – but at grave long-term cost to UK taxpayers, consumers and investors and to others.

Those 'others' include millions of people living in poverty in the developing world, who have suffered in two main ways:

- First, because the same international regulatory weaknesses underlying the crisis have for many years allowed companies and wealthy individuals to dodge their tax responsibilities in countries where revenues are desperately needed to provide basic services such as healthcare; and
- Second, because the impact of the crisis is being felt by these countries as much as by richer countries like the UK. ActionAid has calculated that the total 'lost growth' to developing countries between 2008 and 2010 as a result of the crisis will be \$414 billion.

The crisis has opened up new policy space to reassess the role of regulation, and we welcome the Treasury Select Committee's involvement. Our concern is that the interests of developing countries and their citizens are not overlooked in these discussions, or in the international policy changes that are likely to follow.

## **Our recommendations for the UK government are as follows:**

The UK government should urgently address the issue of financial opacity which has underpinned the financial crisis and also facilitates tax evasion in developing countries on a massive scale.

Addressing the opacity in current corporate accounting is likely to prove a huge task, but at a minimum global accounts must include greater information for investors, regulators and others *at the level of individual jurisdictions*. We propose an International Accounting Standard for country-by-country reporting, which would require companies to report where they are located, and in each location the scale of their economic activity, profits made and taxes paid.

Addressing the opacity provided by secrecy jurisdictions, and at the same time the opportunities for regulatory arbitrage they provide, will also require international measures – ultimately to require the automatic exchange of information between regulators (including tax authorities) in each jurisdiction.

Important first steps for the the UK would be to urgently address the financial opacity in secrecy jurisdictions which are British Overseas Territories and Crown Dependencies, and to ensure that the European Union addresses this issue appropriately and swiftly by expanding the European Union Savings Tax Directive to include trusts and other financial vehicles.

Finally, the UK government should in 2009 push for the establishment of a robust review mechanism for the United Nations Convention against Corruption, which includes important provisions on banking secrecy. It should also encourage its swift ratification by other countries including in British Overseas Territories and Crown Dependencies.

### **1. Introduction**

- 1.1 The financial crisis has already had dramatic effects in the developing world as well as in richer countries like the UK. Christian Aid have shown how development is being threatened by falling income from international trade, investment, remittances and even aid.<sup>32</sup> The costs for UK taxpayers, consumers and shareholders are also increasingly clear.
- 1.2 We therefore concentrate our comments on the first area of the Inquiry's terms of reference, that of *Securing financial stability* – since appropriate international measures in this area are ultimately the only way to protect the interests of the many stakeholders.
- 1.3 In effect, the crisis is the result of a period spanning more than two decades in which financial institutions operating internationally were

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<sup>32</sup> *The Morning After the Night Before: The impact of the financial crisis on the developing world*, Christian Aid, November 2008, <http://www.christianaid.org.uk/Images/The-morning-after-the-night-before.pdf>.

able to create credit far beyond what responsible national regulators would ordinarily have allowed. As with episodes of international financial liberalisation in developing countries, this led to a process of boom and bust. The boom is characterised by high growth of consumption and by bubbles in unproductive assets, especially property, until eventually the bust feeds through from the banking sector into a sharp contraction in real economic activity – with all that this entails for citizens.<sup>33</sup>

- 1.4 In what follows, we set out the ways in which increasing opacity in the financial system allowed such a growth in credit, despite national regulatory efforts. In effect, financial actors exploited the possibilities of financial globalisation and the loopholes that allowed them to escape regulation. Our recommendations focus on ways to address this problem of the misalignment between international markets and national regulation.

## 2. Financial markets and information

- 2.1 Financial markets differ from others in that they are more highly dependent on information. In particular, the role of information has been shown (e.g. in the work which won a Nobel prize for Prof. Joseph Stiglitz)<sup>34</sup> as critical to the performance of credit markets. A banana-seller cares only that their customer has the money to pay for it immediately. A bank selling a loan, however, will usually want to know whether borrowers have the means to pay it back. That will require information about borrower solvency and probity – in particular whether they have assets, a steady income and a good credit history. If this information is unavailable, the bank is unlikely to lend.
- 2.2 However, this analysis is irrelevant if banks have an incentive to make the loan, regardless of whether or not it is repaid. This is the story of the US sub-prime mortgage crisis that triggered the present financial maelstrom. In recent years, mortgage brokers in the United States were systematically engaged in obtaining customers by whatever means they could, knowing that they would be paid on the basis of every loan made, regardless of the customer's subsequent ability to repay the loans.
- 2.3 This behaviour, which in retrospect appears almost criminally negligent, was encouraged by banks keen to extend credit, in the full confidence that the loans made could then be shifted along the chain and sold *en bloc* on the international market for collateralised debt. Those who ultimately

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<sup>33</sup> See e.g. the analysis of post-liberalisation dynamics in Alex Cobham, 2001, 'Capital account liberalisation and poverty', *Queen Elizabeth House (University of Oxford) Working Paper 70*, <http://www3.qeh.ox.ac.uk/pdf/qehwp/qehwps70.pdf>.

<sup>34</sup> See e.g. Joseph Stiglitz and Andrew Weiss, 1981, 'Credit rationing in markets with imperfect information,' *American Economic Review* 71, pp.393-410.

owned the mortgages were in no position to judge their true value, for they knew nothing of the mortgagees' ability to pay. As customer after customer defaulted, mortgage after mortgage turned out to be worthless, leaving serious question-marks over the value of the mortgage 'bundles' that had been sold to them.

- 2.4 The credit-rating agencies, which should have been assessing the risk factor, merely exacerbated matters. They helped design, often for large consultancy fees, the financial instruments through which the mortgages were passed down the chain and sold on. Arthur Levitt, former chairman of the Securities and Exchange Commission, which protects investors in the US, has argued that 'the credit-rating agencies suffer from a conflict of interest — perceived and apparent — that may have distorted their judgment.'<sup>35</sup> Whether faced with a conflict of interest or not, the ratings agencies seem to have fundamentally failed in their role of ensuring efficient risk evaluation across the market.
- 2.5 Banks make their margin, as financial intermediaries, on the difference between the rates at which they borrow and at which lend. The risk they face relates to maturity mismatch – that customers may wish to access their savings quickly, while banks cannot retrieve the loans they have made at the same speed. Because of this, any bank in the world would face closure if enough customers demanded their money back at once, as no bank holds all the customers' savings in cash. It is critical then that withdrawals remain within normal parameters. A panic-stricken run on a bank will take down even the soundest institution. For this reason, banking regulations demand that there are strict limits to the amount of loans a bank can make (or other financial assets it can create or acquire) in proportion to their equity.
- 2.6 As the current financial crisis unfolded, while depositors largely kept faith, the banks (and other financial institutions) effectively did not; they stopped lending to each other. Even the shortest-term markets (eg overnight loans) seized up, and the lending that did take place incurred interest rates far higher than the central banks' policy rates. Financial market players became aware they did not know the value of each others' assets or likely future income streams, and so trust evaporated.
- 2.7 Part of this uncertainty stemmed from factors outside the banks' control such as the likely future performance of the housing market and the economy, which determine, respectively, the value of mortgage and business-loan books. A far greater part of the problem, however, was a direct result of the way in which banks and other financial institutions has been operating in recent years, in particular the lack of transparency surrounding their assets and liabilities.

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<sup>35</sup> Roger Lowenstein, 'Triple-A Failure', *New York Times magazine*, 27 April 2008, [www.nytimes.com/2008/04/27/magazine/27Credit-t.html](http://www.nytimes.com/2008/04/27/magazine/27Credit-t.html)

### **3. The creation of opacity in financial markets**

- 3.1 Opacity was created in the international financial system in two main ways: first, by the increasing complexity of financial products, and secondly, via increasingly complex patterns of business based on regulatory arbitrage and banking secrecy.

#### **3(i) Complexity of financial instruments**

- 3.2 Opacity results from the sheer complexity of the new derivatives – e.g. collateralised debt obligations (CDOs) and credit default swaps (CDSs) – that were created to ‘slice and dice’ the sub-prime debt, and the dangerously small number of people within financial institutions or regulatory agencies who fully understand how these new financial instruments worked.
- 3.3 As long as the markets were going up, few people questioned the true value of such derivatives, but plummeting prices and rocketing defaults in the US housing market eventually forced a reassessment, as investors tried to work out who was really hurting. As bank share prices fell, reassessment also took place in the money markets. Banks started to question the wisdom of lending to each other, knowing as they did what their own assets and liabilities looked like, and so naturally questioning the position of others.
- 3.4 The problem was often one of perception. Bank A may have considered Bank B a sound institution. However, if no one else in the market was prepared to lend to Bank B, then Bank A wouldn’t either, to minimise the risk of default.
- 3.5 Once the crisis broke, the banks compounded the lack of trust by refusing to come clean about what they were really worth. This refusal may have arisen in part from a genuine inability to value their assets, but it had every appearance of being a pretence that there was no real problem. This perceived bluff served only to unnerve investors further, delaying the resumption of normal business, and hence prolonging the crisis.
- 3.6 In short, the massive bail-out operations that have been necessary are the result of the disappearance of trust between banks and other financial institutions. Only the power of state support has proved able to restore that trust; hence part-nationalisation as a solution. As of early January 2008, inter-bank lending has resumed but even now there remains some uncertainty about the ultimate success of the bail-outs that have taken place.

#### **3(ii) Regulatory arbitrage and banking secrecy**

- 3.7 The lack of transparency is also in part the result of the complex way in which banks exploit the difference in banking regulations between

countries where they do business, via 'regulatory arbitrage'. In effect, without wanting to draw attention to their activities, they seek out the legal jurisdictions that will put the least restriction on their activities, and perhaps also charge the least tax on their profits.

- 3.8 This pattern of arbitrage, and the tax haven jurisdictions that facilitate it, gives rise to banking secrecy. Previous large-scale corporate bankruptcies – such as those of Enron and WorldCom – exposed nests of hidden transactions and liabilities, primarily located in tax havens. These structures misled investors about the true value of the companies' assets and liabilities, whether intentionally or not.
- 3.9 The current wave of bankruptcies is no different. The UK parliament saw a session on the nationalisation of Northern Rock bank descend into farce, as it became clear that the government – the new owner – did not know either who owned the Rock's Jersey-based offshore vehicle, Granite, or what, if anything, it was worth.<sup>36</sup> The run on the bank may have been more about panic than fully informed judgment by customers, but that run seems quite reasonable in the light of the subsequent balance-sheet revelations.
- 3.10 In fact, this was part of a wider process – the development of what the Bank for International Settlements (the 'bank for central banks') has referred to as the 'shadow banking system'.<sup>37</sup> This is the setting-up of banks, bank-like institutions, and funds, including hedge funds, private equity operations and structured investment vehicles – conduits used by mainstream investment banks and others – in jurisdictions (tax havens) outside the main financial centres and outside their regulatory reach.
- 3.11 The aim is to escape the type of regulation that banking activities usually face, and of course to reduce the tax bill – even if most actual activity remains in the financial centres and not in the havens. One result is greater opacity, keeping the detail of arrangements largely out of sight (and out of mind) of more stringent regulators.
- 3.12 The regulations these institutions are trying to avoid are those that aim to ensure the solvency of banks and similar institutions by requiring that they maintain some minimum level of capital to guard against adverse

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<sup>36</sup> This issue – like many involving opacity in the current crisis – was first raised and investigated by the campaigning accountant Richard Murphy: see [www.taxresearch.org.uk/Blog/](http://www.taxresearch.org.uk/Blog/). See also *Hansard*, Column 281, 19 Feb 2008, [www.publications.parliament.uk/pa/cm200708/cmhansrd/cm080219/debtext/80219-0023.htm](http://www.publications.parliament.uk/pa/cm200708/cmhansrd/cm080219/debtext/80219-0023.htm)

<sup>37</sup> In fact, the BIS asked: 'How could a huge shadow banking system emerge without provoking clear statements of official concern?' *78th Annual Report*, Bank for International Settlements, Basel, p138, <http://www.bis.org/publ/arpdf/ar2008e.pdf?noframes=1>.

scenarios. In recent years institutions have made increasing efforts to avoid this fundamental check on systemic solvency.

- 3.13 One well-developed example of the key part regulation (or lack of it) plays in this crisis relates to Ireland, although over time many more examples will emerge in many different jurisdictions. Jim Stewart, senior lecturer in finance at Trinity College, Dublin, has highlighted the role of that city's International Financial Services Centre (IFSC) in the crisis.<sup>38</sup>
- 3.14 As he notes, Ireland 'streamlined' its regulation on setting up funds so that 'if the relevant documents are provided to the regulator by 3pm, the fund will be authorised the next day.' This is in spite of the fact that 'a prospectus for a quoted instrument is a complex legal and financial document (a debt instrument issued by Sachsen Bank ran to 245 pages) so it is unlikely it could be adequately assessed between 3pm and the normal close of business (5 pm).'
- 3.15 Ireland was by no means alone in this – there has been a 'race to the bottom' in the regulation of such activity. In Luxembourg, for example, it is possible to set up a hedge fund with 'pre-authorisation approval', as long as the regulator is informed within a month. Moreover, the regulator will not make any checks on elements such as the capitalisation of the fund promoter, unlike in Ireland. The *Financial Times* noted in April 2008: 'Historically, European asset managers' default option was to look to the Cayman Islands, Bermuda or the British Virgin Islands. But more recently European jurisdictions (chiefly the Channel Islands, Ireland and Luxembourg) have been streamlining regulation and beefing up services to get a piece of the ever-growing hedge-fund action. On the margins, the Isle of Man offers a cost-effective solution and Malta is seen as a domicile for the future.'
- 3.16 By July 2008, 19 funds facing problems had been identified as located at the IFSC, according to Stewart. In addition to four German banks with problems at IFSC-located funds, which required almost €17bn of German state aid, Stewart notes that Bear Stearns, one of the largest banking collapses earlier in the crisis, had 'two investment funds and six debt securities listed on the Irish Stock Exchange, and it also operates three subsidiaries in the Dublin IFSC through a holding company' – a holding company which managed to finance \$11,900 of assets for every \$100 of equity. Compared to the international consensus that banks should not

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<sup>38</sup> 'Shadow regulation and the shadow banking system', Jim Stewart, *Tax Justice Focus*, newsletter of the Tax Justice Network, The Research Edition, page 1-3, July 2008, [www.taxjustice.net/cms/upload/pdf/TJF\\_4-2\\_AABA\\_-\\_Research.pdf](http://www.taxjustice.net/cms/upload/pdf/TJF_4-2_AABA_-_Research.pdf)

<sup>39</sup> *Ibid.*

<sup>40</sup> 'Europe stocks shoppers' must-haves', *Financial Times*, p19, Special report: Fund markets, 7 April 2008, [www.ft.com/cms/s/0/2ff2e92c-043a-11dd-b28b-000077b07658.html](http://www.ft.com/cms/s/0/2ff2e92c-043a-11dd-b28b-000077b07658.html)

exceed \$1,250 of risk-weighted assets for each \$100 of shareholder capital (ie they should have shareholder capital equal to at least eight per cent of their risk-weighted assets, as a cushion to absorb losses without hurting depositors)<sup>41</sup> that ratio is a striking indication of the extent to which the shadow banking system is responsible for the enormous growth of credit in recent years.

- 3.17 The type of assets that such a bank would finance would include loans, and the purchase of shares, bonds, related options and derivatives. In this way, regulatory arbitrage led directly to greater credit creation, and to higher asset prices – and so was at the very heart of the long boom that is ending so badly.
- 3.18 Stewart goes on to note that the Irish regulator, the Financial Services Regulatory Authority, appears to consider itself responsible only for ‘Irish banks’ – those with headquarters in Ireland – and hence to question whether anyone had ultimate regulatory responsibility for oversight of investment structures of banks headquartered elsewhere. The German regulator appears to have had at best minimal oversight of the Irish operations of German banks.
- 3.19 This is one example of a potential loophole in global regulations covering holding companies located outside the jurisdiction in which their headquarters are registered. Far from being a problem only for Ireland, it is a common theme in analyses of the shadow banking sector. The *Financial Times* argued in a recent editorial that the greatest regulatory concern at the moment is ‘the supervision of so-called “conduits”, off-balance sheet vehicles which borrow money, finance loans and generally behave just like banks. Most of this activity is regulatory arbitrage – it exists to avoid the restrictions placed on banks – and supervisors appear to have ignored it.’<sup>42</sup> Indeed, the paper continued: ‘If there is to be reform then this is the place to start.’

#### **4. The costs of opacity**

- 4.1 Financial markets are fundamentally driven by the efficient use of information to price assets and liabilities appropriately. Over more than a decade, new asset structures were allowed to develop where no one – not investors nor regulators, nor even market players themselves – could clearly see the underlying value. This complexity was made still more opaque by the deliberate use of tax havens – be it to hide from regulators, tax authorities, investors or competitors.

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<sup>41</sup> According to the Basle II capital accord.

<sup>42</sup> ‘The right response to Northern Rock’, Leader, *Financial Times*, 1 October 2007, [www.ft.com/cms/s/0/3771a632-6fd1-11dc-b66c-0000779fd2ac.html](http://www.ft.com/cms/s/0/3771a632-6fd1-11dc-b66c-0000779fd2ac.html)

- 4.2 The underlying lack of transparency combined with a weakening US property market to cause panic, because it wasn't clear which banks were being damaged, and by how much, by falling property prices and rising default rates. In effect nobody really understood who owned that risk. This led in turn to market players in tax havens, particularly hedge-funds, speculating, with what in effect were large bets, on which banks, and by extension which currencies, would be next to suffer. With the amount of borrowed money that these players could bring to bear, many of these bets turned out to be self-fulfilling prophecies.
- 4.3 In the present crisis, when banks have got into trouble the costs have been borne by national governments (that is, the taxpayers) and the bank shareholders – neither of which groups appears to have had sufficient information to discipline company behaviour effectively. There can surely be no better argument for stronger regulation and greater transparency – not least through improved accounting standards.
- 4.4 Shareholders require information so they can value businesses accurately. National governments require information to ensure that they can regulate business, in order to protect themselves – or rather, to protect taxpayers – from bearing the costs of activities in which they do not share the returns.
- 4.5 Needless to say, the banks do not appear to have repatriated the profits from their shadow activities in order to contribute to the societies which have ended up covering their risk, through paying taxes. In the financial sector, more or less the full risk remains in the original economies. Meanwhile, the tax haven increases its own revenues at the expense of jurisdictions that tolerate its behaviour.
- 4.6 Competing businesses that do not take advantage of this international avoidance mechanism are put at a competitive disadvantage. Those too scrupulous or too small to mimic this behaviour will face a higher level of tax and regulatory scrutiny, and hence are likely to obtain lower levels of post-tax profit – at least until the bubble bursts.
- 4.7 Not, of course, that everyone in a tax haven benefits. As havens from Panama to Jersey have experienced, the top-line economic benefits – even in the good times – have not always been enjoyed by the poorest in those societies.<sup>43</sup> The current reversal is, sadly, likely to see poverty in tax havens worsening considerably – even without international regulatory efforts to curb their damaging behaviour.
- 4.8 Finally, we have long highlighted the extent to which developing countries suffer from related abuses that gave rise to the crisis. In 2008, we

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<sup>43</sup> M Sullivan, 'Ah, Panama', Sullivan, M. *Tax Notes*, 25 June 2007, [www.taxanalysts.com/www/features.nsf/Articles/AC40BDCBDF2CC51385257307007746A3?OpenDocument](http://www.taxanalysts.com/www/features.nsf/Articles/AC40BDCBDF2CC51385257307007746A3?OpenDocument)

calculated that the loss of tax revenues due to corporate tax evasion – based on the exploitation of opacity and a lack of cooperation between national regulators, in this case tax authorities – was around \$160 billion a year: more than one and a half times the total value of aid. For this reason, there could be a silver lining to the crisis – if it prompts global regulatory responses that deliver for development as well as protecting against the likelihood of future crises.

## 5. Implications

- 5.1 Financial markets should be the best way to price assets according to the best information available. However, assets were instead being priced on the basis of a complete lack of information about the nature and ownership of the risk involved. In addition, information was also lacking about who exactly was speculating on market prices. Well-functioning markets have a crucial role to play in facilitating economic progress, but financial markets can only function well with good information and strong regulation. This has been forgotten or ignored by policy makers for too long.
- 5.2 That is why global financial regulation is necessary, and it is hard to disagree with Gordon Brown's pronouncement in New York, as discussions over the US bailout became increasingly heated, that what is needed is 'a new global financial order, founding it on transparency, not opacity'.<sup>44</sup> But some specifics are required. First and foremost, the response must be based on recognition that the extent of global economic and financial integration has surpassed the ability of national regulation systems to cope alone.
- 5.3 This does not mean that the creation of a supranational authority is necessarily warranted, but it does mean – at a minimum – that a new degree of cooperation between jurisdictions is required. Such will be (and are already) the costs to nation states of failed (or absent) regulation elsewhere, that it seems unlikely that the present situation can be tolerated for much longer. Tax havens have not only leeched tax revenues from countries both rich and poor, they have also cost taxpayers in a number of countries dearly as governments have been forced to respond to the crisis.
- 5.4 The leading economies themselves are far from blameless; they have tolerated, if not actively encouraged, this situation for most of the last 30 years. They too should be held to account for their role in the 'age of irresponsibility', to use Gordon Brown's memorable description. Some have suggested however that the UK may be the last great defender of tax havens, now that Barack Obama – a sponsor of the 'Stop Tax Haven Abuse

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<sup>44</sup> Speech by Gordon Brown to the UN on the global economy, New York, 26 September 2008, [www.number10.gov.uk/Page16982](http://www.number10.gov.uk/Page16982)

Act’ – has been elected President of the United States. Of the 70-plus havens around the world, no fewer than 30 are in Commonwealth countries, Crown Dependencies or British Overseas Territories, while the IMF recently identified London itself as a tax haven.

- 5.5 The UN Convention against Corruption contains important provisions which aim to curtail banking secrecy, which allow banks to bank corruptly gained funds ‘no questions asked’. Although the UK government signed the convention in 2006, such has been the UK’s commitment to the network of havens, it exempted all of its Overseas Territories and Crown Dependencies (including the Cayman Islands, which hosted around ten per cent of the world’s estimated 8,000 hedge funds).<sup>45</sup> This decision was made in spite of the widespread recognition that tax havens, apart from their role in undermining financial regulation, are also a key part of the chain of corruption. As the World Bank has noted: ‘While the traditional focus of the international development community has been on addressing corruption and weak governance within the developing countries themselves, this approach ignores the “other side of the equation”: stolen assets are often hidden in the financial centres of developed countries’.<sup>46</sup>
- 5.6 It is perhaps understandable that bankers sought to maximise short-term net profits, without considering the social costs of tax minimisation or regulatory arbitrage, or the longer-term profit implications. But national governments and regulators had a duty to consider these factors. This they neglected, in favour of letting the good times roll.
- 5.7 The new ‘global financial order’ cannot be based on transparency alone. Certainly, that is a prerequisite – information provision by financial market players to investors and regulators, and information exchange between jurisdictions, is necessary to ensure the application of appropriate tax and other regulation. But there must also be a new approach to responsibilities and rights. The costs that the leading economies now face are those of allowing market participants and tax havens the right to participate in global financial markets without meeting minimum responsibilities in return. A framework of international cooperation is needed to ensure that there are no deliberately created regulatory gaps to be exploited, and that participants are held to a duty not to exploit those they may uncover.
- 5.8 On 1 October 2008, as the Sigma fund based in the Cayman Islands closed down, the *Financial Times* reported ‘the end of 25 years of development

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<sup>45</sup> *The Distressed Debt Report*, 27 November 2007, <http://distresseddebt.dealflowmedia.com/reports/112707.cfm>

<sup>46</sup> ‘Stolen Asset Recovery (StaR) Initiative: Challenges, Opportunities and Action Plan’, United Nations Office on Drugs and Crime/World Bank, 2007, <http://siteresources.worldbank.org/NEWS/Resources/Star-rep-full.pdf>

of the shadow banking sector...'. The wind-down of 'the oldest and once the single largest structured investment vehicle, marks the final chapter in an extraordinary project to create a credit industry outside the world of traditional banking', said the paper.<sup>47</sup> There are now fewer vested interests in tax havens left to pander to: much of the shadow banking sector has gone, and won't be back in a hurry, so neither banks nor havens can realistically claim that they will suffer further by the elimination of economic opportunities.

- 5.9 In the medium to long term, of course, the international community will need to take steps to provide alternative development paths for poorer havens. The citizens of tax havens should not be made scapegoats. The international community must recognise that for the poorest in such societies, there have been social and economic costs even at the best of times. Now the international community must help create alternative development paths for havens that are less damaging to the global economy.
- 5.10 This is the end of an era. The only appropriate 'celebration' would be to push through international agreements on information exchange and regulatory cooperation to ensure that there is no chance of a repeat of the systematic abuse of secrecy that has led us here.

## **6. Recommendations to the UK government**

- 6.1 The UK government should urgently address the issue of financial opacity which has underpinned the financial crisis and also facilitates tax evasion in developing countries on a massive scale.
- 6.2 Addressing the opacity in current corporate accounting is likely to prove a huge task, but at a minimum, global accounts must include greater information for investors, regulators and others *at the level of individual jurisdictions*, enabling them to value the real economic activity of their investments and therefore evaluate risk effectively. Christian Aid and ActionAid propose an International Accounting Standard for country-by-country reporting, which would require companies to report where they are located, and in each location the scale of their economic activity, profits made and taxes paid.
- 6.3 Addressing the opacity provided by secrecy jurisdictions, and at the same time the opportunities for regulatory arbitrage they provide, will also require international measures – ultimately to require the automatic exchange of information between regulators (including tax authorities) in each jurisdiction.

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<sup>47</sup> 'Sigma collapse ends shadow bank project', *Financial Times*, 1 October 2008, <http://www.ft.com/cms/s/19db6e24-8fff-11dd-9890-0000779fd18c.html>.

- 6.4 Important first steps for the the UK would be to urgently address the financial opacity in secrecy jurisdictions which are British Overseas Territories and Crown Dependencies. The treasury review of tax havens is an appropriate forum to address this. In addition, the UK should push the European Union to expand the European Union Savings Tax Directive to include trusts and other financial vehicles.
- 6.5 Finally, the UK government should in 2009 push for the establishment of a robust review mechanism for the United Nations Convention against Corruption, which includes important provisions on banking secrecy. It should also encourage its swift ratification by other countries including in British Overseas Territories and Crown Dependencies.

January 2009

## **Memorandum from the Hedge Fund Standards Board**

### **Introduction**

[1] The UK Treasury Committee is seeking to identify lessons that can be learned from the banking crisis and has requested written evidence on (1) Financial Stability, (2) Protecting the Taxpayer, (3) Protecting Consumers, and (4) Protecting Shareholder Interests.

[2] The Hedge Fund Standards Board (HFSB) has been set up to act as custodian of the Best Practice Standards published by the Hedge Fund Working Group in 2008 and to promote conformity to the Standards. It is also responsible for ensuring that they are updated and refined as appropriate. Over 30 managers from the UK and abroad have already committed to the process of the HFSB, and with more managers expected to sign up to the Standards in 2009.

[3] Hedge funds, in common with many other market participants, have been severely affected by the current crisis and the loss of confidence in markets as a whole. The Hedge Fund Standards Board believes that hedge fund managers play an important role in global markets and is prepared to work with policy makers to help create a regulatory environment which will enable the industry to fulfil its mission.

[4] The Hedge Fund Standards Board herewith comments on select questions raised in area (1), Financial Stability.

### **Executive Summary**

[5] 1.3: The HFSB does not see a need for large scale reform of regulation of hedge fund managers in the UK. The industry has behaved in a responsible manner in the UK, and has proved its resilience and the overall benefits of its demanding economic model. However, we are aware of the current concerns of regulators and policy makers throughout the world and we stand ready to cooperate, in order to identify areas where refinement and adaptation of current regulation may be needed. In addition, the HFSB will contribute to the discussion around global convergence of hedge fund standards, as recommended by the G20. The HFSB has already begun to work closely with its counterparts in the US, the Investors Committee and the Asset Managers Committee of the Presidents Working Group, to delineate a global approach to Hedge Fund Standards, also involving various industry associations including AIMA and the MFA.

[6] 1.8: Regulators need a two pronged approach to global financial regulation: Banks, insurance companies, and financial intermediaries with large-scale retail operations must be highly regulated, for prudential reasons, to protect depositors and investors, and to prevent systemic risks. By contrast, hedge funds rely on sophisticated investors, who do not need the protection of regulators. These investors impose very high standards of performance on the industry, weeding out mediocre players. Here, it is imperative that the regulatory environment does not impair the dynamism of financial innovation, including the

provision of investment choices to investors, and capital provision to those who need funding for projects that would otherwise not be viable.

[7] 1.10: There are two ways in which hedge funds could potentially inflict harm on the financial system: 1. Hedge Fund failure destabilising a bank. The HFSB believes that FSA's current approach of assessing the interaction between banks and large hedge funds via its Prime Broker surveys is robust, but would be happy to engage with regulators if there is a need to enhance the current regime.

[8] 2. Run on hedge funds (massive redemptions), causing large scale forced selling in the markets. In times of market panic, concerns can arise if there are perverse incentives, eg investors feel they have an incentive to redeem early or redeem in excess of what they actually want to redeem, forcing hedge funds to be more liquid than they would otherwise be. The HFSB is currently looking into behavioural standards and mechanisms to mitigate such concerns, and will continue to discuss these approaches with the FSA. In addition, the HFSB Standards address detailed practices around liquidity risk management, including stress testing of the funds' liquidity position.

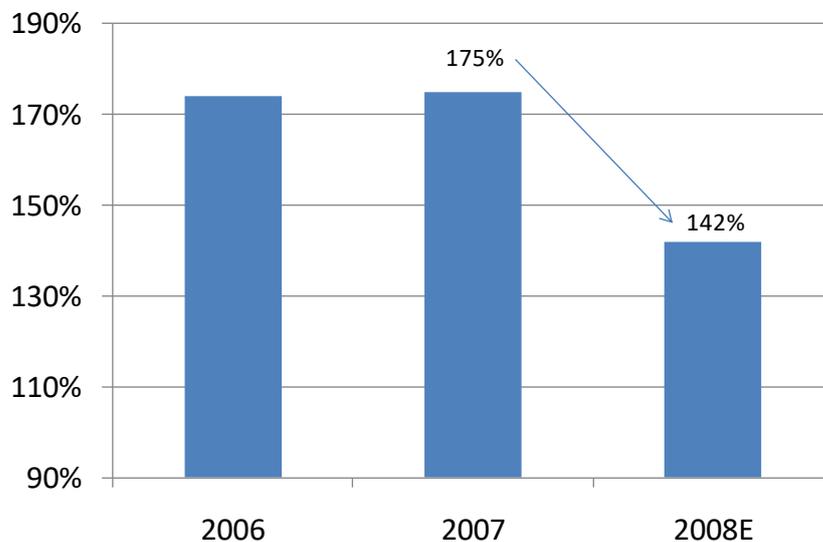
[9] 1.14: The short selling ban has had a detrimental effect on markets, eg causing short term market distortions, impeding bank's capital raising efforts and imposing restrictions on mainstream investment strategies. The HFSB agrees with the FSA decision to let the short selling ban expire on January 16. To enhance disclosure of short positions, HFSB believes that a symmetric disclosure regime for short positions, mirroring the current long disclosure regime is appropriate.

### **The role and regulation of hedge funds in the banking crisis, and whether any reform is desirable (1.3)**

[10] The global financial crisis has highlighted the difference between the banking sector – in particular, deposit taking institutions - and the hedge fund industry: large losses at banks affect their ability to maintain deposits and provide credit to the economy, and ultimately require recapitalisation to ensure capital adequacy ratios are appropriate. Because depositors have the ability to withdraw their funds at short notice, banks depend crucially on confidence. Thus, failures in the banking sector can give rise to concerns about systemic stability, since they undermine confidence in the system as a whole.

[11] Hedge funds, however, absorb losses by translating them into lower values for their investors. Normally, no systemic issues arise, and there is no need for a bailout when hefty losses occur. In contrast to the banking industry, no hedge funds have received taxpayers money during the current financial crisis. Bankruptcies in hedge funds only happen when there is significant leverage. Leverage in hedge funds is much lower than in other financial institutions – in particular banks, where leverage reaches 3000% and more – and it declined significantly in 2008 (see Figure 1), as credit conditions became more onerous. When leverage is modest, liquidation of the fund provides an orderly method to stop operating, with investors absorbing the consequent losses.

**Figure 1: Average Gross Leverage as of Mid-November, 2008<sup>48</sup>**



[12] It is a common misconception that the hedge fund industry is unregulated. In fact, hedge fund managers in the UK need to register and are regulated by the Financial Services Authority (FSA) in the same way as other traditional asset managers. It is important to distinguish the UK regulatory regime from its US counterpart, where there is no obligation to be registered and hedge funds are mostly exempt from regulation. In addition, unlike in the US, independent administration of hedge funds is common practice in the UK.

[13] The FSA's regulatory framework is principles based and therefore creates an environment where hedge fund managers have constantly to be certain that their actions do not contravene those principles, regardless of whether specific detailed rules exist. It also has a mechanism for assessing issues around financial stability. The FSA regulatory framework also addresses behavioural concerns such as valuations, disclosure and market integrity.

[14] All these areas are also at the heart of the best practice Standards of the Hedge Fund Standards Board (HFSB). Its standards cover the areas of disclosure, valuation, risk management, governance and shareholder conduct. The Standards are anchored in FSA's Principles, and thereby provide a translation of these into a framework of discipline for hedge fund managers. The FSA has welcomed the publication of the Standards, and has recently declared that it sees them "as a very constructive addition to the wider regulatory architecture."<sup>49</sup>

[15] So far, hedge fund managers accounting for more than 50% of industry Assets Under Management in the UK have voluntarily committed to the HFSB

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<sup>48</sup> Source: Bernstein Research, Equity Portfolio Strategy: The Fund Deleveraging and Redemption Debate, November 21, 2008, Survey results (consistent with recent IMF survey, IMF World Financial Stability Report)

<sup>49</sup> The regulator's view of hedge funds and hedge fund standards: Speech by Hector Sants, Chief Executive, FSA, Hedge 2008 Conference, 22 October 2008.

Standards. A large number of managers will certainly follow suit over the coming 12 months. This industry-driven initiative, based on the comply or explain principle and relying on self-certification and enforcement by investors, follows a well-tested model which developed in the UK in the context of Corporate Governance codes of conduct. It should help enhance confidence in the hedge fund industry and the financial sector as a whole.

[16] The HFSB interacts closely with FSA to identify and discuss areas of potential concern. This can also include identifying areas where governmental regulation cannot provide the level of practical detail that the industry requires, and where the Hedge Fund Standards can fill that gap and act as the market-based extension of FSA's regulation.

[17] The HFSB does not see a need for large scale reform of regulation for hedge fund managers in the UK. It is our conviction that the industry has behaved in a responsible manner in the UK, and has proved both its resilience and the overall benefits of its demanding economic model. However, we are aware of the current concerns of regulators and policy makers throughout the world and we stand ready to cooperate, in order to identify areas where refinement and adaptation of current regulation may be needed. In addition, the HFSB will contribute to the discussion around global convergence of hedge fund standards, as recommended by the G20. The HFSB has already begun to work closely with its counterparts in the US, the Investors Committee and the Asset Managers Committee of the Presidents Working Group, to delineate a global approach to Hedge Fund Standards, also involving various industry associations including AIMA and the MFA.

### **Improvements to the architecture of international financial regulation and maintenance of global financial stability (1.8)**

[18] The HFSB believes that regulators need a two pronged approach to global financial regulation. Banks, insurance companies and other financial intermediaries with large-scale retail operations must be highly regulated, for prudential reasons, to protect depositors and investors, and to prevent systemic risks. By contrast hedge funds rely on sophisticated investors, with an increasing share of institutional monies. These are knowledgeable and sophisticated – or they have the resources to hire knowledgeable and sophisticated advisors – and therefore do not need the protection of regulators in the way retail investors do. Clearly, hedge funds have to abide by the general requirements of integrity and respect for market rules which underlie the FSA principles.

[19] Hedge funds are subject to very high standards of performance, imposed by investors. Every year, hundreds of hedge funds are liquidated, due to investor dissatisfaction. In parallel, every year hundreds of new funds are created, to launch innovative strategies and test the skill of new managers. This dynamic process guarantees that the market weeds out mediocre performance and that those who survive create value for their investors.

[20] The hedge fund industry is characterized by the extraordinary diversity of investment strategies that it offers investors. This includes the whole spectrum

from very low risk to high risk strategies. This diversity makes an important contribution to overall economic efficiency. Investors appreciate the whole spectrum of options available to them, which allows them to choose the position that best fits their risk-return profile. And those who use capital can find funding for projects or initiatives which otherwise would never be viable. In technical language, hedge funds are a vital contributor to the provision of complete financial markets, with considerable efficiency gains in advanced economies where high standards of capital performance and the ability to handle risks are at the heart of economic efficiency, innovation and technological progress.

[21] It is therefore imperative that the regulatory environment for hedge funds does not impair the dynamism of financial innovation and the ability of the sector to provide investors with all options for risk taking. This is very different from the regulatory requirements for banks or insurance companies and creates a different set of challenges.

### **Risk to financial stability emanating from non-bank financial institutions (1.10)**

[22] The current crisis has demonstrated that the hedge fund industry has been relatively resilient in the face of the recent extreme volatility in financial markets. As mentioned earlier, market losses incurred by hedge funds are transferred to the ultimate investors. Clearly, the downsizing of global financial markets has caused hedge funds to shrink as well, since they are now a mainstream segment of the markets and could not be immune to the dramatic correction that has taken place. The concern arising in this context is not so much the losses incurred by hedge fund investors themselves, but possible after-effects that hedge funds (individually and collectively) can cause to the financial system. There are two ways by which hedge funds could potentially inflict harm on the financial system:

- Hedge fund failure destabilising major banks
- Run on hedge funds (massive investor redemptions), causing large scale forced selling in the markets

#### **Hedge fund failure destabilising a bank**

[23] A bank failure caused by a hedge fund has been a major concern of many policy makers prior to the financial crisis. In fact, the causality has been in the opposite direction in the current financial crisis: the troubles which many banks experienced, culminating in the bankruptcy of Lehman Brothers, inflicted significant losses on hedge funds and their investors.

[24] Since they hold substantial assets in large banks (in particular, broker dealers) hedge funds are significantly exposed to the risk of broker-dealer bankruptcy. If such a bankruptcy were to cause distress to many hedge funds, its consequences could indeed be severely amplified.

[25] Financial stability efforts in this area should focus on the interaction between banks and large hedge funds, and in particular the counterparty risk

exposures arising from direct lending, derivatives and other transactions. This is what the UK FSA seeks to assess via its Prime Broker surveys of banks' exposure to hedge funds, including drill downs into outliers and assessment of the banks' counterparty risk management capabilities.

[26] The HFSB believes that this approach is robust, but would be happy to engage with regulators if there is a need to enhance the current regime.

### **Run on hedge funds**

[27] A second concern is the very high level of redemptions from hedge funds currently observable in the markets and the resulting strain on markets due to forced selling.

[28] Usually, market based systems provide a framework for price discovery, balancing of supply and demand and competition. However, concerns arise if in the context of significant market panic, investor behaviour creates perverse incentives for participants. This is the case if investors feel they have an incentive to redeem early or to demand redemptions in excess of what they actually intend to obtain. It may then happen that short term investors obtain better terms than those who stay invested longer. Also, if pre-emptive redemptions (i.e. investors redeeming for fear of being gated at a later point in time), force hedge funds to be more liquid than they otherwise would, this again is very detrimental to their economic viability.

[29] These externalities are a consequence of the fact that, in the context of the extremely favourable financial conditions of the recent boom, asset-liability mismatches and liquidity mismatches within funds became quite common. Investors developed expectations with respect to the liquidity of their investments, which do not fit with the hedge funds long term strategies, and were often highly disappointed when some hedge funds refused to meet those expectations. Ultimately, how investors respond to the different behaviour of hedge fund managers with respect to redemptions will have significant commercial implications, which investors will certainly sort out.

[30] From the regulatory point of view, while these externalities may cause severe damage to the profitability of the industry and to its long term viability, they are not a direct threat to the stability of underlying markets. Notwithstanding this, we are currently looking into behavioural standards and mechanisms to internalise such externalities, and will continue to discuss these approaches with the FSA. Also, it is important to highlight that the best practice standards of the HFSB address practices around liquidity risk management, including stress testing of the fund's liquidity position by simulating severe market shocks, increases in collateral requirements, cancellation of credit lines, investor redemptions etc.

### **The impact of short selling in the banking crisis and its regulation (1.14)**

[31] Short selling plays an important role in global capital markets, providing overall benefits including investor protection and efficient price discovery, while it also has the ability to dampen price bubbles.

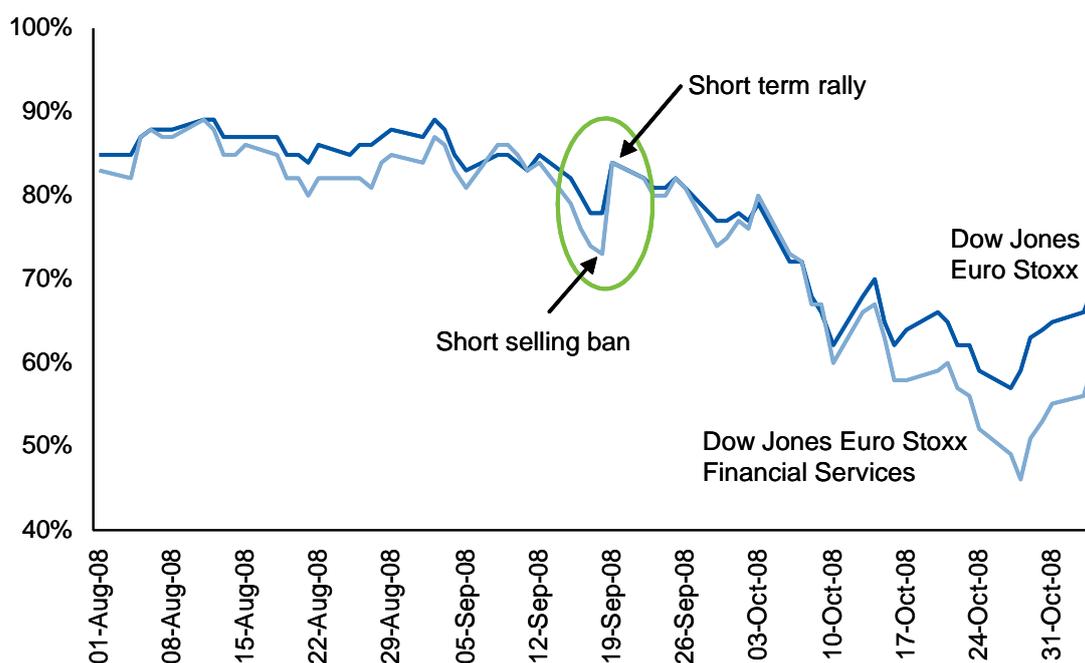
[32] HFSB has found no evidence that disorderly markets due to short selling existed prior to the short selling ban or that short selling contributed to the banking crisis. Falling stock prices for banks were a reflection of the deteriorating confidence in banks and their business models. The collapse of banking stocks was caused by investors selling their long positions, far more than investors building short positions. HFSB sees this as part of the natural operation of markets, when investor sentiment changes abruptly.

The impact of the short selling ban can be described as follows:

### ***Short term market distortion***

[33] The ban provided short term relief for banking stocks, by creating an artificial (short squeeze) rally after the ban. However, it could not halt the price adjustment which was underway, and which subsequently continued with a further decline in market values for banks throughout October 2008 (see Figure 2).

**Figure 2: Evolution of Financial Services Stock vs. Stoxx 50 Index**



The spike in banking stocks created winners and losers in the markets in an arbitrary manner (regulatory hazard), thereby undermining confidence in markets.

### ***Impeding banks' capital raising efforts***

[34] The short selling ban has inadvertently affected other market segments, such as the convertibles market. The convertibles market serves as an important capital raising venue for banks, in particular in times of market distress.

However, short selling of stocks is a vital risk management technique for investors absorbing such convertible issuance. Deprived of this protection, investor interest in convertibles has waned significantly, contributing to the difficulties banks face in raising capital.

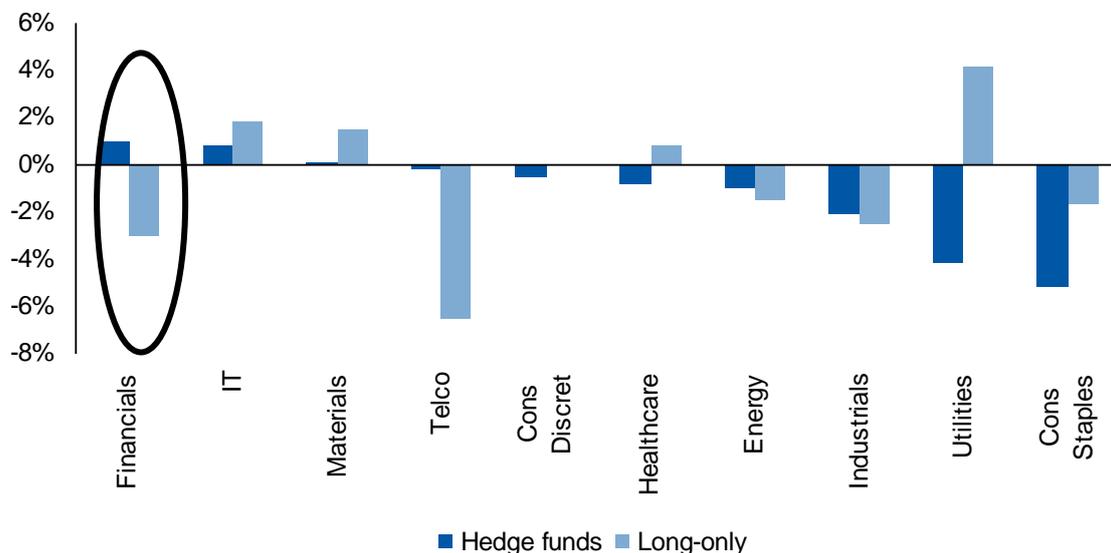
***A further blow to market confidence***

[35] The ban actually sent an ambiguous message to the markets. Regulators have implicitly told the markets that the practice of short selling resulted in distortions in the price discovery process, and more broadly, that it allowed some market participants to manipulate prices. This may have contributed to undermine investor confidence in the markets, since it became clear that regulators no longer trusted the market’s resilience at a time of considerable distress. The ban may have ultimately been counterproductive.

***Restricting mainstream investment strategies***

[36] The introduction of the short selling ban drove many investors away from the markets. Many mainstream investment strategies, which essentially rely on short selling, were suddenly less viable and investors had to sell or reduce their exposure. The short selling ban contributed to the general shrinkage of the market, which disproportionately affected financial institutions. Until the short selling ban was introduced, hedge funds were actually net buyers of financial stocks (see Figure 3). It is also important to note that no single bank was included in the Top 10 FTSE 100 stocks on loan (as a percentage of all outstanding stock) on 8 September (see Figure 4).

**Figure 3: Net flows (4 weeks average prior to 12 September) by sector and fund type<sup>50</sup>**



<sup>50</sup> Source: UBS Investment Research, European Equity Strategy 12 September 2008 (based on internal UBS flow data)

**Figure 4: Top 10 FTSE 100 stocks by % shares on loan (8 September 2008)<sup>51</sup>**

*“no banks among top 10 stocks by % share on loan”*

<b>Instrument Name</b>	<b>% of share on loan</b>
SAINSBURY	34.3
AMEC ORD	25.7
LIBERTY INT	25.3
LON ST EX	22.7
VEDANTA	21.2
THOMAS COOK GRP	19.7
WOLSELEY	19.4
BA	17.7
KINGFISHER	17.4
INTER HTL	15.7

### ***Regulatory implications***

[37] In the short term, HFSB believes that there is insufficient evidence to maintain a short selling ban, and agrees with FSA announcement not to renew the ban on short selling on 16 January 2009. In the medium term, it is important that regulators develop an effective analytical framework to spot disorderly markets (and the cause thereof), and develop an effective toolkit with an arsenal of fine tuned measures for regulators to employ to counteract disorderly markets. It is important that, prior to resorting to more extreme measures (such as a short selling ban), there should be other more appropriate tools to employ.

[38] Discussion has recently emerged around whether there should be a general disclosure regime around short positions, in particular since several regulators have recently enhanced disclosure requirements in this area. The HFSB believes that there are two major motivations behind additional disclosure of short positions, 1. Financial stability, and 2. Market integrity/efficiency.

[39] The following table assesses to whom disclosure is relevant, what type of information should be disclosed, and what potential concerns could arise.

### **Assessment of short selling disclosure regimes**

<b>Factor</b>	<b>Reasoning</b>	<b>Relevance to whom</b>	<b>Type of information</b>	<b>Potential concerns</b>	<b>Application</b>
<b>Financial stability</b>	Enabling regulators to spot and counteract risk of	Regulators	Aggregate short position (eg to assess it in relation to trading volume)	• Cost to collect/aggregate data	Only during times of distress

<sup>51</sup> Source: UBS Investment Research, European Equity Strategy, 12 September 2008. Note: Shares on loan is used as an estimate of shares shorted.

	disorderly markets and financial instability			• Leakage risk of individual position	
<b>Market integrity/efficiency</b>	Allowing better price discovery Allowing transparency for control purposes	All market participants Regulators	Individual (manager level) short positions	• Discouraging information acquisition	Always

[40] There is one important distinction to highlight regarding the disclosure regimes illustrated above. While for financial stability purposes, the aggregate level of shorts is relevant to regulators, it is the individual manager level disclosure that is relevant in the market efficiency/integrity context to all market participants and regulators. In the latter context, the question arises what should be the adequate disclosure thresholds for individual short positions. The HFSB believes that a symmetric approach is appropriate, mirroring the disclosures required in the context of long positions for the following reasons:

- The market impact of long and short positions is similar;
- Underpriced stocks are equally damaging as overpriced stocks from a market efficiency perspective;
- The risk of market manipulation is equally damaging whether it takes place in the form of long or short positions.

[41] Currently, the long position disclosure regimes vary by country. In the UK, the Disclosure and Transparency Rules require disclosure of the combined long position of shares and CFDs if the 3% threshold is exceeded and for each percentage point thereafter (UK issuers).

[42] Beyond establishing a symmetric approach for short disclosures, HFSB would welcome further European/global harmonisation of disclosure mechanisms.

January 2009

## **Memorandum from Jim Raeburn, Scottish Daily Newspaper Society**

I am responding on behalf of the Scottish Daily Newspaper Society (SDNS) specifically to paragraph 1.11 – the role of the media in financial stability and whether financial journalists should operate under any form of reporting restrictions during banking crises – of the terms of reference of the Committee’s Inquiry.

The SDNS represents the publishers and editors of seven major groups – Aberdeen Journals Ltd, D C Thomson & Co Ltd, Newsquest (Herald & Times) Ltd, Scottish Daily Record & Sunday Mail Ltd, The Scotsman Publications Ltd, Associated Newspapers and News International (Scotland) Ltd – whose 18 member titles account for aggregate weekly sales of 10 million in Scotland. In addition, their websites deliver 5.1 million unique online users each month, not including the Scottish editions of UK national newspapers for which separate figures are not available.

The SDNS believes that newspapers have played an important and critical role in their reporting throughout this period of financial crisis. It is their duty to report on matters of genuine public interest including the health and wellbeing of the financial system.

While the sheer volume of the coverage of events means that it is perhaps inevitable that some articles may not have demonstrated the level of accuracy desired, it is also fair to say that the vast majority of reporters and newspapers have taken great care in how they inform readers of unfolding developments and explain to them the implications. Blame should not be attributed to newspapers or the wider media for reporting scares originating with others whose actions do not stand up to close scrutiny.

The SDNS totally and utterly rejects any notion that readers should be deprived of information on financial matters which might assist them in making perfectly rational decisions to secure their investments.

Similarly, the SDNS strongly opposes any suggestion that financial journalists should operate under some form of reporting restrictions during banking crises. Quite apart from the practicalities of any such proposition, this would amount to blatant censorship in breach of Article 10 of the European Convention on Human Rights relating to freedom of expression. It should also be said that financial journalists are already subject to statutory and self-regulatory controls, the latter under the Editors’ Code of Practice administered by the Press Complaints Commission and its Financial Journalism Best Practice Note published in 2005.

*December 2008*

## **Memorandum from the Newspaper Society**

This submission is confined to the following term of reference of the Committee: “1.11 The role of the media in financial stability and whether financial journalists should operate under any form of reporting restrictions during banking crisis”

### **Executive Summary**

1. The Newspaper Society represents the UK local and regional media. The Newspaper Society’s member publications are all subject to the self-regulatory Code of Conduct administered by the Press Complaints Commission.
2. We would strongly oppose the notion that any form of reporting restriction upon the media should be imposed at times of economic “crisis”.
3. The media as such has no “role” in safeguarding financial stability: the role of the media is simply to accurately report news and events.
4. Imposition of any reporting restrictions would be a wholly unjustifiable intrusion into the freedom of the press, and of the individual, and as such an unlawful infringement of Article 10 rights to freedom of expression and to receive and impart ideas under the Human Rights Act 1998. To prevent the public’s right to know about such matters, and to comment and respond to them, would be an unjustifiable incursion into the rights of the individual. The media have not just the right but also the responsibility at times to act as the public’s “watchdog” and to sound the alarm. It is inappropriate to in effect elevate economic downturn and financial mismanagement to the same status as defence of the realm and to seek to apply restrictions which in some cases would be greater than those applying in matters of national security.
5. Any restrictions in order to be meaningful would have to apply to the world at large not just the media: this is unworkable and impractical in the internet age.
6. There is no regulatory gap to be filled. The media are subject to the provisions of the Financial Services and Markets Act 2000 on market manipulation and insider dealing, including the prohibitions on disseminating false or misleading information. This followed extensive discussion and consultation between the media and both the UK Government and the Commission, during the passage of the Directive on Insider Dealing and Market Manipulation (Market Abuse). The legislation acknowledges the relevance and application of the self-regulatory codes applying to the media. The general requirements of the PCC Code – in particular Clause 1, Accuracy, apply to all financial journalism but in addition the PCC has produced specific detailed guidance on financial reporting.

7. No evidence has been produced of any malpractice or misreporting by the media during the current economic crisis. There has been no call for any restrictions on the media from the banking and financial industry. Any attempt to impose controls on the media will inevitably be viewed as an attempt to “bury bad news”.

## **SUBMISSION**

1. The Newspaper Society represents the UK local and regional media. Our members publish 1300 newspaper titles, paid for and free, daily and weekly, circulating throughout the UK, as well as 1200 websites, over 600 magazines and ultra local titles, 45 radio stations and 2 TV stations. Across all its print, online and broadcast channels, the local media delivers news and information to over 40 million people a week.
2. The Newspaper Society’s member publications are all subject to the self-regulatory Code of Conduct administered by the Press Complaints Commission. Local and regional newspapers are strong supporters of the Code. A copy of the current Code, and the additional PCC guidance on financial journalism, are attached as Annex 1 and Annex 2.
3. The Newspaper Society was amongst the foremost media organisations which held extensive discussions with the Treasury Ministers and senior officials during the original passage of the Financial Services and Markets Act 2000. We made extensive representations to the Commission in relation to the provisions of the Directive on Insider Dealing and Market Manipulation (Market Abuse) as they affected the media and subsequently were involved in detailed consultation with HM Treasury in relation to the implementation of the Directive in the UK via the Financial Services and Markets Act 2000 (Market Abuse) Regulations 2005 and the Financial Services and Markets Act 2000 (Investment Recommendations) (Media) Regulations 2005. Throughout, our concern was to ensure that the legislation in imposing controls upon the financial industry should reflect and respect the very different role of the media in reporting and commenting upon financial matters and in particular should allow for the media to continue to apply its own self-regulatory code in respect of certain issues. But it is important to note at the outset that the media did not seek, and was not accorded, any form of general “exemption” from the legislative controls affecting matters such as market manipulation and insider dealing. It is also important to clarify that the media as such has no “role” in safeguarding financial stability: the role of the media is simply to accurately report news and events. It also has the right to comment and criticise, as does any other citizen.

The media has no rights or responsibilities towards the financial sector or in respect of the economy of the country other than those which attach to the public as a whole. The law as it affects the media in the UK is based firmly upon the starting premise that the media enjoys the same rights and has the same responsibilities in law as does the public and is, with a few

narrow exceptions, not regulated as a special case or given special privileges save where to do so has been found necessary in the public interest.

4. We would strongly oppose the notion that any form of reporting restriction upon the media should be imposed at times of economic “crisis” for the reasons set out below.
5. The first and most obvious objection to any such control is that it would be a wholly unjustifiable intrusion into the freedom of the press, and of the individual, and as such an unlawful infringement of Article 10 rights to freedom of expression and to receive and impart ideas under the Human Rights Act 1998. The freedom to report and to comment on current affairs, even where such publication is unwelcome, awkward or alarming – whether to the Government of the day, particular investors or anyone else – is a cornerstone of democracy and a vital bulwark of civil liberty. Statutory curbs on free speech are very rare, and Parliament and the courts have rightly imposed such restrictions only where vital, for example, the security of the state (the Official Secrets Acts) or for the preservation of public order and the protection of rights of others (curbs on incitement to racial hatred, or on the publication of material which would seriously prejudice active court proceedings, for instance) and such controls are inevitably the subject of intensive Parliamentary debate and scrutiny. It is worth bearing in mind that even the “DA Notice” system operated between the media and the Ministry of Defence, whose object is to prevent the publication of material which might cause a real and serious security risk, is an entirely voluntary system. To somehow equate and elevate reporting on financial mismanagement with the defence of the realm seems, at the least, a questionable analogy. To seek to prevent the public’s right to know about such matters, and to comment and respond to them, would, we submit, be without precedent and would quite simply represent an affront to the principle of freedom of expression and indeed an unwarranted incursion into the rights of the individual. How could this be justified? The accurate reporting of all manner of “bad news” can produce a public reaction, both generally and individually: reporting a plane crash caused by a design defect, for example, could affect the share price of the aircraft company, the jobs of its workers and the pensions of its ex-employees, and could cause individuals to cancel booked flights or to not book with that airline – with attendant “ripple” effects upon the holiday and travel industry. The media have not just the right but also the responsibility at times to act as the public’s “watchdog” and to sound the alarm: indeed, one argument which has been raised in relation to the current situation is that the media should perhaps have been quicker and more vociferous in exposing and criticising the banking practices which led to the economic crisis.
6. It should also not be overlooked that any restrictions would also have to be applied not just to the “media” but to the world at large: to curtail only the media’s rights to comment and report whilst allowing others to do so would be pointless. On the other hand, to seek to restrict all publication would be

unworkable in the Internet age. The well-nigh impossibility of suppressing publication across jurisdictions was amply demonstrated over 20 years ago, in the Spycatcher saga.

7. Secondly, it should be borne in mind that the media in reporting and commenting upon the banking crisis are not operating in a legislative vacuum. The media are subject to the provisions of the Financial Services and Markets Act 2000 in respect of behaviour which constitutes market abuse – and this includes specifically “the dissemination of information by any means which gives, or is likely to give, a false or misleading impression as to a qualifying investment”, or “a false or misleading impression as to the supply of, demand for or price or value of, qualifying investments” or behaviour which is or would be likely to be regarded as behaviour that “would distort, or be likely to distort, the market in such an investment”. These provisions derive directly from the EU Directive on Insider Dealing and Market Manipulation which makes clear that “market manipulation” includes the dissemination of rumours and false or misleading news where the person making the dissemination knows or ought to have known that the information was false and misleading. Both the Directive and the Act acknowledge and require that in assessing the conduct of a journalist in relation to these provisions, the codes governing his profession should be taken into account: hence the direct and important role played by the PCC Code (and other relevant self-regulatory codes applying to the media such as the BBC Guidelines and the OFCOM Broadcasters Code) in regulating financial journalism. The general requirements of the PCC Code – in particular Clause 1, Accuracy - apply to all financial journalism but in addition the PCC has produced specific detailed guidance on financial reporting (see Annex 1 and 2).

In addition to legislative and self-regulatory controls specific to financial reporting, the general law will of course apply to all financial journalism including for example, libel, malicious falsehood, breach of confidence, and negligent misstatement.

8. Finally, there has been no evidence produced of which we are aware which in any way points to any malpractice or misreporting by the media of the current economic crisis. Indeed, the only criticism – and which seems to be the genesis of the suggestion of imposing restrictions – seems to be that the media has been all too accurate in its reportage. There has been no call for any restrictions on the media from the banking and financial industry and the undesirability – and futility – of such a suggestion was recently acknowledged by Richard Lambert, Director-General of the CBI<sup>52</sup>. This is not a time for the financial industry, or for that matter the Government, to risk being seen as attempting to “bury bad news”. Indeed, the words of the Financial Times’ columnist Stefan Stern are particularly apposite: “The best leaders can not only handle bad news, they seek it out. They want to “confront the brutal facts”, in Jim Collins’s phrase, and they insist on getting

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<sup>52</sup> Richard Lambert, Speech at Reform Media Group 2<sup>nd</sup> December 2008.

up-to-date, accurate information. Poor leaders not only hate bad news, but they sometimes blame the deliverer. At Lehman Brothers, Richard Fuld seemed unable to accept just how grave the bank's position had become. Unappealing but necessary rescue deals were rejected – until too late. Leaders who put a ban on bad news are setting themselves up for disaster. The messenger can appear in many forms: a boardroom colleague, a customer, a spouse or a child. Perhaps in 2009 leaders will be keener to learn the bad news a bit quicker.”<sup>53</sup>

December 2008

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<sup>53</sup> Stefan Stern, Financial Times, 30 December 2008

## **Memorandum from the Investment Management Association**

### **Executive Summary**

1. The causes of the banking crisis are many and complex. There are lessons to be learned for virtually everybody involved. The primary causes lie in the imprudence of banks worldwide, driven by the “originate and distribute” model, increased leverage and massive growth in the complexity of products and their interrelationships. This was a global phenomenon, in which the UK was as complicit as everybody else. The US sub-prime crisis was merely the trigger. If that had not set the crisis off, something else would have eventually.
2. But there are also lessons for regulators, auditors, ratings agencies, non-executive directors and shareholders. It is reasonable to expect regulators to assess the sustainability of the current bank business model, not least now that significant taxpayer funding has been provided. It may be that oversight should distinguish certain bank activities, particularly those fulfilling a utility function, from others. In this regard it is important to note that the utility role covers not just consumer-focused services, such as payments and deposit protection, but also capital-raising and some secondary market activities.
3. Governments and legislators worldwide therefore need to consider whether the current legislative framework for banking services should be modified. While some issues can be addressed at national level – the problems with UK insolvency law and market practice revealed by the Lehman collapse – fundamental reform to the way banks are structured and do business must also be tackled by co-ordinated international action.
4. We do not believe that institutional reform as such is the solution. Ensuring effective working of the Tripartite Committee is more important than tinkering with responsibilities within it. And we consider improved co-operation, not new global regulatory structures, to be the key to more effective regulation in future.

### ***Getting out of the present crisis***

5. The actions taken by the authorities so far have largely been correct: the reforms to banking legislation; their use in the Bradford & Bingley rescue; and the bank recapitalisation scheme. We welcome the intention of UKFI to operate so far as possible as a normal institutional shareholder and not to seek to use the government’s position as a major shareholder to further social policy objectives. The more that partially nationalised banks operate on a fully commercial basis, the more readily can they be returned to full private sector ownership in due course.
6. A necessary condition is that investment management firms should believe that investing in the banking sector will generate an appropriate return for their clients. Recent experience has dented their confidence in the sector. For banking to become an attractive investment once more, investors need to be confident that the banks have fully written down their losses, whether resulting

from opaque and complex financial instruments or as a result of the current recession.

7. It is only after this process is complete that banks will be able to increase lending. While doubts remain about the quality of a bank's balance sheet, the more difficult it is to undertake new lending on a properly prudent basis.

8. Ultimately the banks need to sell underperforming assets. In principle, this should be done by marking them down to such a level that other investors are prepared to buy them; this has not yet happened on a large scale. Ultimately the option of splitting bank assets in to a "good bank" and "bad bank" should not be ruled out.

### ***Future regulation and the role of banks***

9. There is no doubt that banks fulfil a public utility role in certain of their functions. This utility role is not confined to retail customers, but is also extremely important in the wholesale and capital markets. At the same time it is vital for banks to be able to fail – or indeed, to be rescued without disruption to the public utility. Otherwise, bank managements would face no moral hazard, and there would be an imbalance in the risk and reward faced by banks and the taxpayer respectively.

10. The new banking legislation will help to provide a more appropriate balance in retail banking. But an imbalance remains in the capital markets. In particular the Lehman collapse has revealed serious problems in the London market which need to be addressed as a matter of urgency.

11. The future approach to regulation needs to acknowledge that banks fulfil a number of roles which are essential for economic activity, while ensuring that moral hazard continues to apply. Ideally, no financial institution should be too big or too complex to fail. The consolidation seen in the banking system in response to the crisis is a retrograde step in this regard. Radical solutions to this conundrum should not be sought on a national level unilaterally: were the UK to impose more severe requirements than other major jurisdictions it may simply damage London as a financial centre without resolving the underlying problems in the banks.

### ***The role of investors***

12. There are two broad ways by which shareholders exercise discipline over the companies in which they invest: by selling shares or engaging with management and boards. Both were used in relation to the banks in the period leading up to the crisis. But neither was effective in preventing it.

13. From about 2005, a number of active investment managers concluded that the strategies being followed by many banks were unsustainable, and that they

should not keep their clients invested in the sector. The resulting sales of shares were likely to have been one factor in the underperformance of the banking sector relative to the market as a whole, which was by some 9% in 2005. But these market signals appear to have had little or no restraining effect.

14. During this time, those managers not in a position to sell their shares, for example those running index funds or with mandates from pension fund clients which did not allow them to depart very far from the index, began to express concerns to some bank boards about strategic direction, and stepped up the amount of engagement they undertook. However, it is now apparent that this engagement did not achieve the desired results, and this highlights the limits on what engagement can achieve. We expect this to be confirmed by the IMA's fifth survey of shareholder engagement, which is currently underway and will be published later this year.

15. Although shareholder approval is required for major corporate actions they do not set strategy nor are they insiders, in that they only have access to information that is available to the market as a whole. Managers compensate for such information asymmetries by diversifying portfolio construction. Furthermore, it is now apparent that some bank boards and even managements seem to have been unaware of the risks they were running, so it was difficult for shareholders to second guess them.

16. The IMA considers that the investment management industry needs to consider carefully the events of the last two years in banking and to draw lessons for the future.

### **Detailed responses to the Committee's questions**

17. IMA<sup>54</sup> welcomes the opportunity to submit evidence to the Committee in connection with its inquiry into the lessons that can be learned from the banking crisis. Our detailed comments are set out below, following the structure in the Committee's call for evidence. We would draw attention in particular to the following points:

- The question needs to be asked as to whether the auditors asked the right questions at the time. (Paragraphs 18 - 22)
- It would be preferable to step up scrutiny of markets, rather than attempt to regulate hedge funds. (Paragraphs 30 - 35)

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<sup>54</sup> IMA represents the asset management industry operating in the UK. Our members include independent fund managers, the investment arms of retail banks, life insurers and investment banks, and the managers of occupational pension schemes. They are responsible for the management of approximately £3 trillion of assets, which are invested on behalf of clients globally. These include authorised investment funds, institutional funds (e.g. pensions and life funds), private client accounts and a wide range of pooled investment vehicles. In particular, the Annual IMA Asset Management Survey shows that in 2007, IMA members managed holdings amounting to 44% of the domestic equity market.

- We support the proposed financial stability role for the Bank of England, but we do not advocate further radical change to the tripartite structure. (Paragraphs 36 - 37)
- We do not believe there is a need for a new global regulatory architecture, about which political consensus would be extremely difficult to achieve, but there needs to be renewed co-operation between regulators internationally. (Paragraphs 49 - 51)
- The Government's recapitalisation programme was the correct, indeed the only, response to the situation faced in mid-October, but the restoration of investor confidence will also require the removal of underperforming assets from bank balance sheets. (Paragraphs 80 - 85)
- The Government should not distinguish between those banks in which it has a stake and others for the purposes of wider public policy objectives. (Paragraphs 86 - 94)
- The international debate on the lessons of the credit crisis will need to take account of the important public utility fulfilled by the banks and to address how this can be done in a way which allows imprudent firms to fail. (Paragraphs 87 - 93)
- Shareholders responded to the growing problems in the banks by, in some cases, selling shares and, in others, stepping up engagement with boards. But there were limits to what they could see and do. Nevertheless, the investment management industry needs to consider carefully the events of the last two years and draw lessons for the future. (Paragraphs 105 - 115)

## **Securing financial stability**

### ***The role of auditors in the banking crisis, and whether any reform to that role is desirable.***

18. Reliable and clear financial accounts are essential to the restoration of confidence in the financial markets. Institutional investors, as the holders of ordinary shares, provide the risk capital and bear the residual risk and, as the primary users, they want accounts that are transparent and comparable, and where the audit opinion is both robust and objective. We believe the question needs to be asked as to whether the auditors asked the right questions at the time.

19. International accounting standards follow a principles-based approach and require judgment to be exercised. Specifically, in the context of the banking crisis, the financial instruments concerned and the accounting standards that specify requirements for their recognition, measurement and disclosure are complex and have exposed shortcomings in both management's implementation and auditors' interpretation. In many instances auditors followed accounting standards in an overly mechanistic way without applying sufficient professional judgment. Thus accounts were produced and signed off:

- Where large liabilities held in off balance sheet vehicles were not disclosed;

- Where the sophisticated agreements that linked the institutions to the vehicles or that made it possible for counterparties to trade protection instruments, such as credit default swaps, had not been properly interpreted;
- Where disclosures of valuation methodologies were inadequate, particularly in the case of financial instruments where reliable market data was no longer available and institutions had to "mark to model" as opposed to "mark to market".

20. Auditors are required to follow detailed procedural requirements as set out in auditing standards. They may have followed these to the letter but we consider that questions need to be asked whether more professional judgment should have been exercised. The current crisis originated in the collapse of the leveraged loan and inter-bank loan markets – banks still originate loans but no longer carry them through to maturity. The true value of such assets is the present value of their future cash flows. We think both management in the first instance and then the auditors should have raised questions about the borrowers' ability to meet their obligations and about what authentication procedures had been followed, either by the institution holding the asset or by the originating lender.

21. For some time our members have been concerned about the quality of audits, particularly in view of the liability reforms in the Companies Act 2006 (allowing auditors to limit their liability to a proportionate amount) in that exposure to liability induces service providers to be more diligent and reducing it could induce a lower quality of service. Our members also feel excluded from what they perceive are the real findings of the audit. Investors would like better communication with the auditors on the basis that that there is too little focus on reporting to shareholders.

22. Furthermore, it is not only audit quality that needs to be questioned but also the structure and governance of the audit firms. The recent report from the Basel Committee on Banking Supervision on audit quality<sup>55</sup> noted that whilst the large international audit practices have a global presence, they are not managed globally and do not "provide sufficient public information about how the firms are managed on a global basis, how audit quality is assured at the global level, or about their worldwide overall financial condition and profitability".

**We consider that the question needs to be asked as to whether the auditors played a role in the current crisis and whether they asked the right questions at the time.**

***The role, and regulation, of credit ratings agencies in the banking crisis, and whether any reforms are desirable.***

23. Credit rating agency ratings are just one opinion amongst many which professional investors assess when coming to an investment decision. They do not seek to tell the investor anything about the value or liquidity of an

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<sup>55</sup> Bank for International Settlements, Basel Committee on Banking Supervision, External Audit Quality and Banking Supervision, December 2008.

instrument, but simply the probability of default and the potential loss in the event of default.

24. There may, however, have been over-reliance by some investors on credit ratings as an objective standard of quality. IMA was one of the parties which prepared and published in December 2008 guidelines relating to the over-reliance of asset managers in relation to structured credit products - 'Asset Management Industry Guidelines to Address Over-Reliance upon Ratings<sup>56</sup>'. More generally over-reliance was exhibited:

- By investors who do not have access to un-conflicted credit analysts (in contrast UK-regulated asset managers who commonly have a team of their own analysts).
- In investment regulations and also less-sophisticated investment mandates which draw absolute distinctions between investment-grade and other instruments.
- In capital regimes, and unsophisticated models based upon them.

25. The IMA believes that the adoption of ratings by regulators into some of their rules has had the effect of conferring upon the agencies excessive legitimacy.

26. It is important to distinguish between the ratings process for corporate bonds and that for structured finance. The former is based on the analysis of a specific company. Structured finance, however, relies on mathematical modelling of expected default rates and correlation of default within the underlying asset pools. These models have clearly proved to be flawed, in part because they had a limited historical performance record. It is in this area that the credit rating agencies are open to most criticism.

27. The “originate to distribute” model for structured finance products, in addition, has inherent conflicts of interest for the rating agencies. In order to maintain a flow of revenue from the issuers/arrangers of these instruments (investment banks), the CRA is incentivised to assign favourable ratings so that the issuer will bring it repeat business. The IMA also believes it to be the case that the rating agencies diverted resources to initiate structured product ratings, at the expense of continued monitoring of those ratings.

28. In terms of regulation, the IMA believes that the self-regulatory regime introduced by the IOSCO Code of Conduct in December 2004<sup>57</sup>, and amended in March 2008<sup>58</sup>, did lead to a subsequent improvement in transparency in the corporate bond market.

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<sup>56</sup> <http://www.investmentuk.org/press/2008/20081211-01.pdf>

<sup>57</sup> IOSCO Code of Conduct Fundamentals for Credit Rating Agencies Dec 2004

<sup>58</sup> IOSCO The Role of Credit Rating Agencies in Structured Finance Products March 2008

29. The events of the past year and a half however in the credit markets have exposed weaknesses in this self-regulatory regime, specifically in the repeat business of structured finance whereby issuers bring regular business to the CRAs. The IMA therefore has supported the EU Commission's proposals<sup>59</sup> for a directive/regulation of the agencies as long as the regime is proportionate and focuses specifically on internal organisational structures, internal governance, avoidance and management of conflicts of interest and the quality of ratings and transparency obligations, rather than the content and methodology of the ratings themselves.

***The role, and regulation, of hedge funds in the banking crisis, and whether any reforms are desirable.***

30. We would distinguish between two significant areas of activity:

- Hedge funds as investors in the stock market. Many of the investment techniques deployed by those calling themselves hedge funds are also used elsewhere in the 'mainstream' industry – e.g. 130/30 and other forms of long/short funds – and are not problematic per se (see paragraphs 65 – 73 on short-selling). The issue then becomes whether some hedge funds have engaged in abuse or behaved in ways that could legitimately be described as detrimental to market stability. However, that is a more general issue about behaviour of market participants, and is not special to hedge funds.
- Hedge fund activity in the shadow banking system (i.e. unregulated lending sector). One part of the credit crisis narrative is the major shift in lending that has taken place from regulated to non-regulated/non-banking entities in an environment where 'originate and hold' behaviour by commercial banks had been increasingly replaced by an 'originate and distribute' approach. Within what one market participant and commentator has termed 'the shadow banking system', hedge funds were sometimes using very large amounts of leverage to borrow short and lend long into highly illiquid vehicles (e.g. CDOs with US sub-prime exposure). In this respect, the role of hedge funds might be considered within a wider examination of how 'originate and distribute' approaches went wrong.

31. Although both these areas are very broad, and illustrate that hedge funds are just one type of investor among many in the market, there are reforms that could be considered. Better governance of non-UK based hedge funds – for instance in achieving a full separation between the custodian of the assets and the manager of the fund – would be desirable. However effective regulation of this may not be

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<sup>59</sup> EU Proposal for a Directive/Regulation of Credit Rating Agencies Nov 2008

realistic, as it would require regulation to be imposed extra-territorially and would also involve remote scrutiny.

32. However, the means by which all investors, including hedge funds, gain access to markets is already subject to regulation. In the UK, this is principally through the investment banks. In the case of hedge funds this is frequently through prime brokerage services based in and operating from the UK. This relationship provides the single most important link to the markets for the hedge funds, whether to organised markets such as exchanges, or whether to market makers and other services offered by the prime broker. Without the brokers, the hedge funds cannot deal. We believe this point of connection to the markets is where regulators should step up the intensity of their oversight.

33. As well as prime brokers, organised markets such as exchanges and MTFs have an important role to play in monitoring hedge fund use of markets. Exchanges possess much information about their own market and analytical tools for assessing it and what is happening in the wider market. The exchanges can, under given conditions, share information with regulators and require the provision of additional information about trading activities from members, including in respect of their clients. UK recognised investment exchanges attract statutory immunity in the carrying out of their recognition functions, which puts them in a powerful position vis-à-vis a member firm when instigating an investigation.

34. Risk factors directly relevant to markets include prolonged market disruption and erosion of investor confidence, liquidity disruption leading to disorderly markets (such as the inability to price assets), risk management weaknesses and market abuse. None of these risk factors is uniquely brought about by hedge funds. All have been experienced during the credit crunch, because of its impact on the business of banks as market intermediaries. **We believe the better course of action is to step up scrutiny of markets, rather than attempt to regulate hedge funds to achieve the same end.**

35. The Lehman collapse is likely to cause significant changes to the prime broker model due to the potential losses of assets linked with re-hypothecation. Alongside the global restrictions and reviews concerning short-selling, a greater concern amongst investors about leverage, the credit crisis and Madoff, this may mean the future hedge fund industry could look very different than from the last 2 years.

***Ongoing reforms to the operation of the Tripartite Committee, and cooperation between the relevant public sector authorities.***

36. The form of any framework is less important than the effectiveness with which it is operated. In our view an impression was created in the aftermath of the run on Northern Rock that the authorities were not completely at one on the causes of or the response to the crisis, and that clear leadership was not forthcoming. There has since been a marked improvement in the way the system has worked. In particular, the recapitalisation of the banks and the restructuring

of Bradford & Bingley were handled in a decisive and authoritative fashion, and have significantly improved perceptions of the authorities' actions.

37. We warmly welcome the new financial stability role that has been created for the Bank of England. Responsibility for financial stability needs to be clear. It is not something that necessarily sits well with the prudential and conduct of business supervision of financial institutions carried out by the FSA, and the Bank's closer proximity to the markets than the Treasury's makes it the logical place for responsibility to reside. **Beyond that, we do not advocate further radical change to the tripartite structure.**

***The impact of European Union directives on financial stability, including "passporting".***

38. We do not believe that the EU directives have had an adverse impact on financial stability.

***Possible reforms to the remuneration structures prevalent in financial services.***

39. We believe there is widespread agreement on the need to reform of remuneration structures.

40. Currently, in the UK investors can only engage with remuneration issues at board level and even then only have a non-binding advisory vote on the remuneration report. In the US shareholders have few, if any, rights to appoint and dismiss directors and advise on remuneration issues.

41. There are a number of moves afoot to address remuneration practices in financial institutions. We consider there are a number of issues that need to be addressed in any package of reforms.

42. First, any approach needs to be industry-wide so that changes to the remuneration structure in one institution do not result in an exodus of key staff to its competitors. However, should institutions – particularly those in the US – cooperate with each other then we understand there is a risk that they could fall foul of the competition authorities. Thus it would be helpful if the authorities could look at this issue.

43. Secondly, there needs to be more transparency about the remuneration culture in an institution, say within the business review; remuneration policies should be discussed at board level, and the whole board should take responsibility for them. Where in relation to individual board members independence is an issue, the remuneration committee should continue to decide.

44. It is not sufficient simply to defer bonuses. Many major investment banks already required a proportion of annual bonus to be deferred as shares which have to be held for a period of time. In these instances, staff tended to discount

the deferred shares and focus on the portion paid in cash. We believe the period over which performance is measured should be changed to match it better to the period where it is determined whether a particular deal is profitable or not. This is likely to mean measuring performance over three years at a minimum.

45. Lastly, remuneration and bonuses should not be controlled through arbitrary limits but be related to the risks the institution is exposed to. For example, traders' bonuses should be affected by the risks taken by, say, including a cost of capital charge, i.e. the higher the executives' pay the higher the capital requirements. Moreover, the risk management function should be integrated into the overall strategy and people in risk management should be better remunerated to ensure it attracts quality people. We understand that in Goldman Sachs, risk management was embedded in that staff rotated from trading to risk control areas and vice versa. An increasing emphasis should be placed on the role of risk committees - these are not currently included in the Combined Code.

#### ***Reforms to regulatory capital and liquidity requirements.***

46. The Capital Requirements Directive has only been fully applied across the EU since 1 January 2008, and there has not been sufficient time for it to bed down. In particular, many firms had not yet met the requirement for financial institutions to disclose information in order to improve market discipline. It is not therefore possible to assess what impact the CRD would have had on financial stability.

47. It is, however, clear that the directive requirements in relation to liquidity are insufficient to cope with the events which occurred in 2008. Additional requirements must therefore be introduced to ensure banking institutions have sufficient liquidity available.

48. Any action needs to be proportionately applied; the risks related to one business type are not necessarily present across all others. For example, an investment management firm does not accept deposits, does not lend to clients, does not deal on own account and any client money is held in segregated accounts. Therefore, any amendments to the capital and liquidity requirements must be recognised and differentiated between firm types to ensure the proportionate application.

#### ***Possible improvements to the architecture of international financial regulation and maintenance of global financial stability.***

49. The global financial markets consist of a series of national or regional markets, and responsibility for their supervision should rest there. However many financial institutions operate in many, if not all, regional centres, and regulators need to take account of this. **This does not require new global regulatory architecture, about which political consensus would be extremely difficult to achieve, but renewed co-operation between regulators internationally.** This has at times proved challenging, even within

the European Union and transatlantically. Renewed efforts therefore need to be made to broaden and deepen communication between regulators.

50. A good current example is the rules restricting short selling, which vary significantly between jurisdictions (see paragraphs 65 - 73).

51. Another illustration is international accounting standards. IMA members invest in global companies and in different jurisdictions, and so IMA has strongly supported the convergence of accounting standards globally. It would have been far too ambitious to expect a single standard to have been developed for use worldwide. But a steady process involving the US authorities, the International Accounting Standards Board (IASB) and interested stakeholders has allowed convergence to develop to the point where the US authorities have agreed to allow overseas issuers with a US listing to file accounts prepared under IASB standards and are looking to allow them for their own issuers. This approach of co-operation and mutual recognition has been shown to be the most practical way forward.

***Regulation of highly complex financial products, and the future of the “originate-to-distribute model”.***

52. One contributory cause of the crisis is that banks originated loans but no longer carried them to maturity, giving little incentive to assess the quality of these assets. In addition, instruments created to hedge risks moved away from their original purpose and became traded as stand-alone items. So instead of mitigating risk, the new securities and derivatives created risks, which were parcelled up and passed on to other investors.

53. These complex financial products were also opaque, only being traded over-the-counter (OTC) rather than through formal exchanges with standardised structures. Traders ignored the inherent risks on the basis another party could always be found to buy the instruments concerned. The role of credit rating agencies (see paragraphs 23 - 29) only compounded these problems.

54. We consider that these complex financial products can only be regulated through high level generic rules or principles; new product development will always outrun detailed product development. Measures could include moving OTC contracts onto more formal markets with clearing to eliminate counterparty risks, and determining how the ratings agencies' model could be changed to address conflicts of interest. Finally, it is essential that any actions taken in relation to the originate-to-distribute model should be coordinated at a global level; otherwise they will be ineffective and result in competitive disadvantage for those who implement them.

***Risks to financial stability emanating from non-bank financial institutions.***

55. While we are not aware of other sectors which may give rise to the same level of risk as the banks, there are potential systemic issues associated with most types of institution.

56. So far as the traditional asset management sector is concerned, regulators generally and rightly regard it as low risk. That is because client assets are held separately from the manager, and losses by the manager would not put at risk client funds, unlike institutions where client funds are held on the balance sheet.

***The role of the media in financial stability and whether financial journalists should operate under any form of reporting restrictions during banking crises.***

57. While it is certainly possible for news reporting and press comment to cause volatility in financial shares, this is outweighed by the role of at least some portions of the media in exposing suspicions and problems in parts of the financial sector. Any attempt to impose restrictions on reporting or comment would not calm what may be a critical situation; it would be more likely to do the opposite, and the cost of reporting restrictions would be a period of price malformation. In addition, it is more than likely that restrictions would actually increase the potential for market abuse as news leaked to a selected few.

58. We see no reason why the press should not be able to sound the alarm to the extent that it sees there are dangers present, whether from inappropriate business models or other reasons. Indeed, silencing the media would make the regulator's job more, not less, difficult.

59. There is however a second point, which is the concern that insiders may have at certain points leaked information to the media. In this case, however, there is ample legislation on the statute books to prosecute those who do so. It should be made clear to people with such information that it is market sensitive, that its leakage is an offence under the Market Abuse Directive and that individuals could be subject to prosecution.

***Monitoring and surveillance of financial stability problems by the public sector.***

60. Regulators do not have an easy job. It is always difficult for public sector organisations to keep up with developments in fast moving financial markets, and any regulatory system predicated on the assumption that they can is doomed to failure. Moreover, regulatory successes frequently do not enter the public domain because they are about preventing things happening, whereas failures will inevitably attract wide publicity. This often gives a distorted view of the effectiveness of regulators.

61. The one comment we would make is that the authorities both in the UK and elsewhere have in the past been slow to seek the views of investors (the "buy side") on financial stability issues, and have tended to be over-reliant on the views of the banks and brokers (the "sell side"). Too frequently, market issues are discussed and agreed with those who provide the market rather than those who use it. But financial markets need to run in the interests of all users, the end

investors on whose behalf investment managers act as well as the issuers of capital. We believe regulators need to give this greater attention in future.

***The role of the banking system within the overall economy.***

62. The banking system serves a number of different functions within the UK economy. A number of its roles are in the nature of public utilities, for example:

- Providing money transmission, cash management services and finance to individuals;
- Providing similar services to businesses;
- Market making in capital markets, leading to liquid markets enabling capital to be raised, investments to be priced and investors to invest.

These activities are vital to the operation of a modern economy.

63. In addition, the UK banking and financial services industries have achieved significant success in attracting global business to the UK market. There are many reasons for this, including the openness of the UK economy, the regulatory environment in financial services, the presence of large pools of capital in the asset management industry, and the central nature of the UK time zone. This makes a significant contribution to UK GDP and the trade balance.

64. It is the “public utility” aspects of banking that lie behind the long-standing recognition of the need to regulate banks. Regulation has taken the form of prudential regulation, designed to ensure that they system has enough capital to manage risks and to stay in operation without further Government intervention. In the present crisis in developed Western economies, this framework has manifestly failed. We address the implications of this in paragraphs 87 - 93 below.

***The impact of short-selling in the banking crisis and its regulation.***

65. Short selling is both a legitimate investment strategy and an important risk management tool. It also contributes to market liquidity, reduces transaction costs and assists in ensuring pricing efficiency. Consequently, the development of a globally consistent and practical short selling regulatory regime is a critical matter for securities markets around the world.

66. The IMA has recognised and accepted the need for the temporary ban on short selling of certain UK companies, in the particular circumstances of the autumn of 2008, notwithstanding its impact on managers’ ability to manage their clients’ assets.

67. We are completely opposed to the use of shorting techniques, or any other strategy, to commit market abuse. However, market abuse is already well covered by FSA rules, although their previous position of not explicitly referring to short squeezes or settlement failure risks needs to be addressed. Naked

shorting should require a higher level of evidence that steps to secure stock for settlement have been taken, than is currently the case.

68. We consider that there is no need for the current temporary disclosure of short positions to the market to continue. The FSA has stated that short selling restrictions are 'primarily *about market conduct, rather than transparency*', and that it does 'not consider there to be a strong argument for disclosure on the grounds of general transparency'. We agree with this stance. The evidence regarding the impact of the recent measures taken by the FSA regarding short selling seems, at best, mixed.

69. The following chart sets out the average daily returns and standard deviation of returns for banking stocks in the run-up to the imposition in June of new disclosure requirements, in the period up to the ban in September, and finally in the period following the ban. They show clearly that the decline in the shares and their volatility steadily increased as the rules on shorting were tightened. This does not lend support to the idea that short selling was a primary cause of either the fall in prices or their volatility.

**Chart 1: Share prices movements and volatility**

	Average daily return		Daily standard deviation of returns	
	FTSE 100	FTSE 350 Financial	FTSE 100	FTSE 350 Financial
<b>3 Months to 19th June</b>	0.05%	-0.04%	1.11%	1.43%
<b><u>Introduction of Disclosure requirement on Shorting stock in rights issue period: 20 June</u></b>				
<b>20th June - 18th September</b>	-0.23%	-0.20%	1.62%	1.94%
<b><u>Introduction of Shorting Ban for all UK Financial Sector stock: 19 September</u></b>				
<b>19th September - 31 December</b>	-0.07%	-0.42%	3.70%	3.48%

70. Secondly, the international rush to ban shorting (whether naked or covered, financial stocks or all those listed on a national market) has resulted in a plethora of different rules being hurried out by national regulators. These have been difficult to find, even harder to ensure compliance with.

71. It is noticeable that the US and Canadian regulators have now rescinded their ban of covered shorting, as have the Australians, who had gone furthest in banning even covered shorting on all stocks. We understand that the Chinese have also recently moved, for the first time, to allow short selling of equities. Press reports, which are supported by anecdotal accounts from our members, have suggested that Banco Santander has been heavily shorted since the UK ban as a proxy for the UK banking sector.

72. It is important that there is a consistent approach to any controls on short selling, and that these are evidence based. To date the evidence does not seem to show that bans on short selling, or enforced market disclosure, are effective.

73. In summary, we are not convinced that there is any evidence that short selling made a significant contribution to the current banking crisis, and we think that significant damage is being done to the investment market due to the fragmented nature of the controls put in place by national regulators. We therefore warmly welcomed the FSA's announcement on 5 January that the ban would not be renewed.

### **Protecting the taxpayer**

#### ***The advantages and disadvantages of the UK Government's response to the banking crisis, including comparisons with alternative approaches adopted in other jurisdictions.***

74. Once the Banking Bill has been passed the Government should be put in a much better position to deal with crises of the sort that unfolded over the last year, than it was at the time. It is unfortunate that the lessons have had to be learnt from bitter experience, but we consider that the framework should enable future banking failures to be dealt with quickly and cleanly.

#### ***The nationalisation of Northern Rock and Bradford & Bingley.***

75. The Northern Rock nationalisation was a protracted affair. It highlighted the difference between a bank being solvent on a cash flow basis and a balance sheet basis, the difference between long-term solvency and short-term liquidity. The rules do not currently reflect the importance of a bank's short-term ability to meet its liabilities. Given that, commonly, well supervised banks should not have a deficit of assets, but may be prone to a 'run', it is important that the Threshold Conditions reflect the need for sufficient liquidity.

76. We therefore applaud the introduction of a "special resolution regime" to allow authorities to address failing banks. Markets require businesses to be able to fail. The objective of the regulators is not, and should not be, to avoid bank failures. The objective is to ensure that such failures do not threaten the system. The proposed administrative powers will permit speedy closure of the failed and transfer of deposits and assets to the successful.

77. The introduction of the emergency banking legislation, which also provides for bridging banks, as used in the failure of the Heritable Bank plc and Kaupthing Singer & Friedlander Limited, allowed the nationalisation of Bradford & Bingley (B&B) to be accomplished more rapidly in the end. We remain, however, concerned that investors lost £300m when certain investment management firms were persuaded to support the B&B rights issue only weeks before they were nationalised. This money has been lost and investors will receive no compensation.

78. The B&B process went rapidly through the steps of the FSA declaring that the bank no longer met its Threshold Conditions, the FSCS declaring it in default and the Bank of England arranging the sale of its assets to another bank. This

allowed swift disclosure of the cost of the bank's nationalisation, enabling the market very quickly to price in the developments.

79. The model Code of Practice requires some further refinement, particularly as regards how to handle bonds, but it provides an understandable and predictable framework, which should result in its needing to be used less often in future. The Code ought to be the place in which to clarify the process to follow in the event of future bank collapses; at present it is not. This should be rectified.

***The Government's recapitalisation programme, and part-nationalisation of major high-street banks.***

***The aims, objectives and exit strategy of the Government's investments in UK financial institutions.***

***The role of UKFI and its relationship with the part-nationalised banks.***

We deal with these three questions together.

**80. The Government's recapitalisation programme was the correct, indeed the only, response to the situation faced in mid October.**

81. A prior question is why, if the banks needed further capital, this could not have been raised from the private sector in the normal way. Investors had already provided significant support to the banks in question. As well as the B&B rights issue referred to above, RBS had raised some £12 billion via a rights issue in June this year, and HBOS's £4 billion rights issue had been successfully underwritten. But all these investments were effectively lost.

82. Investment managers owe a fiduciary duty to their clients, most of whom are ultimately individual savers or pension scheme members. The previous capital raising exercises had been shown to be insufficient, and there was – and remains – a widespread view in the investment management world that the Government-underwritten round of recapitalisation might not be the final one. In those circumstances, many managers took the view that their duty to their clients obliged them not to invest further in the banking sector. The responsibility for ensuring that the banking sector had sufficient capital therefore became one for the economy as a whole, through the agency of the Government. In the circumstances this was probably inevitable.

83. We welcome and support the Government's stated intention to seek orderly disposal of its investments over time. There are several pre-requisites of successful disposal:

- Investor confidence that the banks in question have fully recognised losses on their balance sheets, and that the process of recapitalisation has run its course;
- Confidence that the banks are operating on a fully commercial footing;
- A price that investors consider to offer long term value.

84. To that end, UKFI's professed aim of operating as an institutional

shareholder is to be welcomed. As a shareholder in a public company it cannot, in any event, be privy to information above and beyond that which is the public domain without taking “insider” status.

**85. The restoration of investor confidence will require not only the recapitalisation of banks but also the removal of underperforming assets from bank balance sheets.** This can take various forms:

- Writing them down to levels which investors believe represents their true value;
- Disposal to another party;
- In the extreme, separation of underperforming assets from sound ones – the so-called “good bank/bad bank” solution used in some previous crises. The “good bank” would be recapitalised and brought back to a position of viability, and the “bad bank” would go through a managed wind-down under either the shareholders or the Government. This process is not yet in prospect in the UK, but should not be ruled out as a possible response if other measures do not succeed.

These are also necessary preconditions for the banks to start lending again.

### **Protecting consumers**

***The role of banks in receipt of public investment in fulfilling the Government’s aspirations for assisting customers, and small businesses, in financial difficulty.***

**86. The Government should not distinguish between those banks in which it has a stake and others for purposes of wider public policy objectives.** A perception that the Government was seeking to use its shareholding in certain banks as an instrument of policy could make disposal more difficult, for the reasons explained in paragraphs 80 - 85 above, and significantly extend the period during which the Government was obliged to retain the shares.

***The importance of retail banking as a “utility”, and whether retail banks should be separate from other activities such as investment banking and insurance provision.***

87. The banking system provides an important public utility to both the retail and wholesale markets.

88. In a market economy it is vital that businesses should be able to fail. Without the knowledge that mismanagement can lead to failure, executive management face no moral hazard. If risks may be taken for short term gain, secure in the knowledge that the public sector will step in to rescue the business, there is an unacceptable mismatch between the risk and reward faced by the institution and by the taxpayer.

89. The public utility role must therefore be capable of surviving failure by individual institutions.

90. As discussed in paragraphs 75 - 79, the Government's banking legislation goes a long way towards addressing this for retail customers. This does not, however, deal with other utilities which the banks provide. In particular the collapse of Lehman has left in its wake a chaotic set of problems in the London capital markets, which are likely to take several years to sort out. In the capital markets it does not appear possible for firms to fail with consequences that can be dealt with in an orderly fashion. In this respect the situation in the UK seems to be significantly worse than in the US and in other centres, and the Banking Liaison Group, set up by the Treasury to monitor the operation of the new banking legislation will be considering whether changes are needed to insolvency law to address this.

91. Longer term, it is legitimate to ask the question whether such an important utility should be able to carry on unrestricted high risk ancillary business. The banking system created within itself structures of such complexity and interconnectedness that those in charge appeared no longer to understand the risks that were being run and the consequences of an external event, the US sub-prime crisis eventually being the trigger which unleashed a chaotic sequence of events.

92. After the not dissimilar events of 1929, one response in the US was the Glass-Steagall Act of 1933, which among other measures, prohibited a bank holding company from owning other financial institutions, until its repeal in 1999. The concept did not finally disappear until this autumn, when the last two independent investment banks adopted bank holding company status. As a result "universal banking" is now the global model.

93. While the Glass-Steagall formula of separating retail from wholesale banking might at first sight appear superficially attractive, it would not address the issues identified above, since it would not capture the distinction between utility and purely commercial activity. Not would it be advisable for the UK to pursue a course of separation other than as part of a global initiative, since that would be very likely to damage its competitiveness as an international financial centre. **Nevertheless the international debate on the lessons of the credit crisis will need to address how to provide this important utility in a way which allows imprudent firms to fail.**

***The impact of deposit protection on both consumers and competition.***

94. The Deposit Protection Scheme has worked very well in terms of giving customers of failed banks expeditious access to their money. But understanding of the scheme by consumers remains generally poor. A key practical point, which creates real difficulty for consumer understanding, is that the FSCS limit applies to an individual's exposure to an entire deposit-taking group. So, if someone has deposits with, what they believe to be, regional banks, which are

actually owned by a national with whom they also have an account, the limit will not be as generous as it seems.

95. The Government has however effectively established a policy, through a series of precedents, that deposits with any UK authorised bank will be protected, irrespective of the deposit protection limit. It needs to develop a strategy to pull back from such an absolute guarantee, which goes against the intention of the deposit protection legislation.

96. The FSA recently introduced a rule change to enable separate compensation limits to apply when two building societies merge. This adds a further layer of complexity to the regime, and more importantly, introduces moral hazard in that there is then a competitive advantage for any such societies in comparison with two banks merging, or existing holdings within a financial services group. Furthermore, this ruling will prevent diversification of deposits due to the increased amount protected under the compensation scheme for deposits with merging societies.

97. The key message for the public should be, and should always have been, to spread risk. This is a key mantra that the new Money Guidance service needs to say at each interview/in each correspondence. It is important that this message should get across. One possible way to do it might be to require banks to notify customers when their combined accounts reach the compensation limit.

### ***The role of financial advisers in the banking crisis.***

98. We believe the role of independent financial advisers during the crisis has been positive:

- They do not appear to have put clients in large numbers into structured investment products exposed to the Lehman collapse. This is in contrast to other countries, for example Germany and Hong Kong, where large number of retail investors found themselves directly and unknowingly exposed to Lehman and lost money after its collapse.
- There has been no evidence of panic selling by UK investors. In the first 11 months of 2008 retail investors have added nearly £3 billion to their investment in retail funds, and while there has been some movement out of equity funds, it has been less than 1% of the total, and relatively at the very bottom of the market. IFAs can take credit for advising their clients well.
- In contrast, other European countries, notably France, Spain and Italy, have seen very large scale redemptions over the last two years. It is notable that in these countries distribution of investment products is in the hands of the banks (which have seen the redemptions flow back as deposits) rather than independent advisers.

### ***The impact of the banking crisis on consumer confidence in financial institutions.***

99. So far as retail fund management products are concerned, as indicated above we see little evidence of investors selling up. Of course many are very disappointed at the steep falls in the value of their investments, which may be a large proportion of their retirement savings, but this is mainly manifesting itself as a reluctance to invest fresh funds rather than in a desire to exit altogether.

100. An IMA You Gov survey conducted in November 2008 amongst over 3000 investors found that 56% felt the investment market had got worse over the previous six months – compared to only 26% in May. 39% expect it to get worse over the coming six months, almost double those who thought so in May 2008. Investors are becoming increasingly risk averse with current market uncertainties putting them off investing further. They have become even more cautious since May and feel a growing scepticism towards the markets. This is perhaps not surprising, given the sharp falls in markets and the value of investments, over the autumn.

### **Protecting shareholder interests**

#### ***The rights of shareholders in the context of new sources of investment, including the UK Government and sovereign wealth funds.***

101. In the UK, shareholder rights are embodied in the company's Articles of Association and in the Companies Acts. In the UK in recent years the profile of listed companies' shareholders has changed from individuals to institutions - in 1963 individuals held over half of UK company shares, today they hold about an eighth. There has also been an increase in the number of foreign shareholders - in 1963 they held less than a sixth of UK company shares but in 2007 held around half<sup>60</sup>.

102. Through the agency of UKFI, the UK Government will become a major shareholder in at least two major banks. We hope and expect that it will operate in the same way that a private sector shareholder, because this will be in the interests of the Government, for the reasons explained in paragraphs 80 - 85.

103. In addition, sovereign wealth funds have, we understand, invested more than US\$60 billion in financial groups mainly originating in the US and Switzerland<sup>61</sup>. This has made a welcome contribution to liquidity and stability. The experience of IMA member firms is that SWFs have been long term shareholders, exhibiting all the signs of responsible stewardship, interested in stability and whose interests are congruent with those of other investors. A number of SWFs are in the process of finalising a set of voluntary principles and practices.

104. The significance of alternative investment providers needs to be kept in perspective. SWFs, in particular, have grown dramatically in recent years, but, as

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<sup>60</sup> Tomorrow's Owners, Stewardship of Tomorrows Company, Tomorrow's Company October 2008.

<sup>61</sup>[www.ifsl.org.uk/upload/CBS\\_Sovereign\\_Wealth\\_Funds\\_2008.pdf](http://www.ifsl.org.uk/upload/CBS_Sovereign_Wealth_Funds_2008.pdf)

at end 2007, they were reported to have US\$3.3 trillion under management; hedge funds US\$2.3 trillion; and private equity US\$ 0.8 trillion. However, this is small relative to the assets institutional investors manage: globally, pension funds, insurance companies, and mutual funds in aggregate have US\$74.9 trillion<sup>62</sup>.

***The responsibilities of shareholders in ensuring financial institutions are managed in their own interests.***

105. Institutional investors owe a fiduciary duty to their clients, the beneficial owners, for example, the beneficiaries of a pension scheme or holders of mutual fund units. Their overriding responsibility is to ensure that the companies in which they invest deliver satisfactory returns for their clients. As part of that process they exert discipline over the companies in which they invest to try to maximise long term performance.

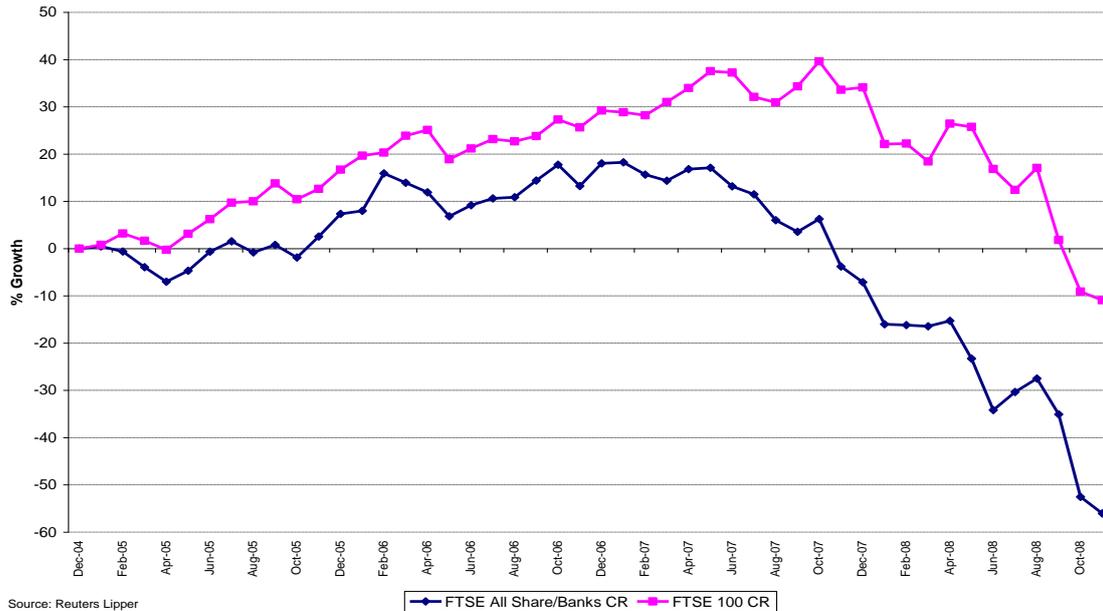
106. The first discipline is through the medium of the market. If enough active managers are unhappy with developments and sell the stock, there will be an impact on the share price. Traditionally, this acts as a signal to management that all is not well, and the threat of hostile takeover may ultimately force a change of strategy or management.

107. There are signs that this process had been going on in UK banks for some time. A number of IMA members have told us that they began to exit the banking sector as long ago as 2005 because of concerns about strategic direction. This is to an extent borne out by the following chart which compares the performance of the FTSE 100 and FTSE banking sector indices over the last four years. From December 2004 to December 2005, for example, the FTSE 100 rose 16.7% whereas the FTSE banking index clearly underperformed, only rising by 7.3%. While many factors are at work in driving share prices, it is likely that growing disenchantment among some fund managers will have contributed in some measure to this underperformance.

***Chart 2: Performance of FTSE 100 and FTSE All Share/Bank Indices to end November 2008.***

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<sup>62</sup>[www.ifsl.org.uk/upload/CBS\\_Sovereign\\_Wealth\\_Funds\\_2008.pdf](http://www.ifsl.org.uk/upload/CBS_Sovereign_Wealth_Funds_2008.pdf)



108. Other investors will not have been in a position to sell. They may have been managers of index funds, for example seeking to replicate the performance of the FTSE 100, or they may have been given mandates by their institutional clients which do not allow them in practice to be heavily underweight such a major sector. Such investors would, if unhappy, have no alternative but to raise their concerns with the company concerned, seeking to ensure that their concerns are addressed, ultimately voting against management if they are not.

109. In 2002, City institutions gave new impetus to effective engagement through new principles (the Statement of Principles) drawn up by the Institutional Shareholders' Committee (ISC), whose members, including the IMA, represent virtually all UK institutional investors<sup>63</sup>. This was the first comprehensive statement of best practice governing the responsibilities of institutional investors in relation to the companies in which they invest, on behalf of the ultimate owners.

110. IMA has benchmarked the industry's adherence to the Statement of Principles through regular surveys. The latest published survey<sup>64</sup> covered 33 IMA members who collectively managed £640 billion of UK equities, representing 68% of the market. It showed broad general compliance with the principles, and an increasing trend for engagement to be integrated into the investment process, complemented by regular dialogue with senior management and monitoring.

111. We are currently completing our fifth engagement survey and to date have asked 23 firms who together managed £517 billion of the £640 billion cited

<sup>63</sup> <http://www.investmentuk.org/press/2002/20021021.asp>

<sup>64</sup> <http://www.investmentuk.org/press/2007/20070704.asp>

above about their engagement on financing issues with Bradford and Bingley and the Royal Bank of Scotland. The results are summarised in Chart 3 attached which shows that the 11 firms with a holding in Bradford & Bingley in aggregate had 55 meetings with the non-executives and/or executives on financing issues and the 18 firms with a holding in the Royal Bank of Scotland had 59 meetings. While the raw figures understate the full extent of the dialogue that in many instances took place, it is clear that the investment management industry stepped up the amount of engagement.

112. However, it is now apparent that this engagement was not necessarily effective and it is important to recognise that there are limits on what engagement can achieve. In particular at a time of relatively easy credit banks are able to raise funds at very fine prices, and may become less reliant on their shareholder base.

113. First, investment managers are restricted in terms of the information that is made available to them. They do not have insider status and were not privy to the same information as the executive or indeed the non-executive directors. Furthermore, in many instances it is now apparent that the boards and management of financial institutions failed to fully appreciate the risks on their balance sheets, thus, investment managers could not have been expected to either; this was not a problem which could have been avoided by better engagement. Managers compensate for such information asymmetries by diversifying portfolio construction.

114. Furthermore, although shareholders in the UK have the right to dismiss and appoint directors, these rights are not universal. We consider that the debate in the US on the right to appoint and dismiss directors should be progressed so that boards can be better held to account.

**115. In conclusion, there are various degrees of engagement, from buying or selling shares, to deciding voting rights, to activism, to really focused engagement. Specifically as regards financial institutions, the gap between performance in the banking sectors and the FTSE suggests that a number of managers did dispose of their shares. Those that did not sought to engage but there were limits to what they could see and do. That said, we recognise that there have been failings and that the investment management industry needs to consider carefully the events of the last two years and draw lessons for the future.**

*Chart 3: 23 managers' engagement with B&B and RBS on financing*

	Bradford & Bingley	Royal Bank of Scotland
	Number of meetings (members)	
Insignificant holding so little or no engagement with bank	(12 members)	(5 members)
		27

	<b>Bradford &amp; Bingley</b>	<b>Royal Bank of Scotland</b>
	<b>Number of meetings (members)</b>	
Chairman	17 (9 members- one meeting also with the Senior Independent Director and four also with the Finance Director)	(14 members – one meeting also with the executives, two with the Senior Independent Director, one with the Chief Executive, one with the Chief Executive, Finance Director and IR and two with IR)
Senior independent director	3 (2 members)	6 (5 members)
Chief Executive	2 (2 members)	13 (8 members)
Finance director	2 (2 members)	3 (3 members)
Executives	2 (1 member)	
Company secretary	-	2 (1 member)
Investor relations	-	4 (3 members)
Met/spoke with Texas Pacific Group, the private equity that pulled out of the fundraising.	(4 members)	N/A
Met/spoke with Resolution – an alternative bidder	(1 member)	N/A

January 2009

## **Memorandum from Which?**

1. Which? campaigns actively for all consumers and is the largest consumer organisation in Europe. Entirely independent of government and industry, we are a registered charity funded through the sales of our consumer magazines, online products and books.

2. Which? has long pressed for consumers to get a better deal from the UK banking system and we welcome the opportunity to respond to this inquiry. Information on our current banking reform campaign for simpler, safer, stronger banks can be found at [www.weownthebanks.co.uk](http://www.weownthebanks.co.uk).

### **Executive Summary**

3. This submission details Which?'s response to the Committee's inquiry. It focuses on our key areas of interest and concern rather than addressing every aspect of the inquiry. These are:

#### **Passporting**

4. We are particularly concerned by two particular aspects of passporting:

- > Compensation arrangements for passporting firms either need to be prefunded or guaranteed by the home state government.
- > Collaboration between national regulators is currently inadequate, especially for smaller firms, and therefore needs to be strengthened.

#### **Originate to distribute model**

5. The model has made a notable contribution to extreme lending practices that border on the irresponsible and encourage market instability, but an entire rejection of it would lead to a substantial contraction in the availability of mortgages, with significant negative implications for consumers. We propose ways the model can be reformed to deliver greater efficiency, access and lower cost, while ensuring responsible lending and stability.

#### **UKFI and part-nationalised banks**

6. We want to see public representation on the UKFI board, including the appointment of an explicit consumer champion, to reflect the taxpayer support received by the nationalised and part-nationalised banks.

#### **Customers in financial difficulty**

7. While recognising that there will be an adjustment in the cost and availability of credit, it would be very damaging to go from 'feast to famine'. We welcome the measures that the Government has already taken to protect those in financial difficulties, but we have specific concerns about treatment of borrowers in arrears whose mortgages have been securitised and believe further action by the FSA and Government may be necessary to protect consumers.

### **The importance of retail banking as a ‘utility’**

8. Which? believes basic retail banking does constitute a utility. While there are different definitions of what retail banking as a utility might look like, a sensible proposition might be to see it simply as a payments system and basic deposit taking service. These are facilities which are basic to consumer use of banking services. However, retail banking is only one area in which consumers are affected by the fallout of the economic crisis. In our view, appropriate protection can only be achieved by making the regulatory regime for both retail and investment banking more effective and by introducing stronger questioning and enforcement into the supervisory process.

### **Consolidation within the retail financial services sector**

9. Our long-standing concerns about the lack of effective competition in the retail banking sector have been significantly increased by recent changes in market structure. While accepting the importance of preserving stability as a priority, specific measures are needed to ensure consumers are not adversely affected in the future.

### **Product pricing**

10. We detail the negative trends for consumers of pricing in mortgages, credit cards and store cards following the recent banking crisis. Which? welcomes the new code of conduct agreed by BERR with the credit card companies, but believes that it may ultimately not be enough. The OFT, FSA, Banking Code Standards Board and Financial Ombudsman Service must take a robust approach to firms altering interest rates unfairly. There is also a case for a full and transparent review as to whether credit card companies have been breaching or continue to breach the Unfair Terms in Consumer Contracts Regulations and treating customers unfairly.

### **Protection of UK citizens investing in non-UK jurisdictions**

11. We do not see a case for the UK taxpayer to underwrite investment overseas for individuals that have not paid the UK tax that funds the relevant protection. However, greater clarity is needed on financial promotions and in explanatory literature to make any reduced levels of protection clear to consumers.

### **Depositor protection**

12. Further to the proposals we have previously submitted to the committee, we believe that the speed of payouts has to be increased significantly and that the current proposal to reduce the payout time to 7 days is an absolute minimum. Every effort should be made to achieve a payout period of 3 days or less.

### **Consumer confidence**

13. There is a contrast between consumers’ faith in the banking sector as a functioning system, i.e. a belief that money under the control of a bank will be safe, and a lack of emotional trust that the bank will act primarily in the interest of the consumer. Recent consumer experiences with, and knowledge of, unfair charging, misselling of financial products, and excessive and unwarranted

bonuses have all undermined the sector in the eyes of consumers. It is in the long-term interests of the banking system to improve consumer confidence in the sector.

**The impact of European Union directives on financial stability, including “passporting” (1.5)**

14. Our concern about the impact of European Union directives is focused on the passporting arrangements under the Second Banking Directive. We expressed some of our concerns about passporting arrangements in our earlier submission to the Treasury Select Committee’s inquiry into Banking Reform in July 2008.

15. Which? has always been supportive of the aim of the European Commission to provide better and more competitive financial services to European consumers. However, we have also warned against achieving this by lowering regulatory hurdles to such an extent or in such a way that consumers are exposed to unacceptable levels of risk. UK consumers have access to a range of financial products with differing levels of complexity and the UK regulatory regime and compensation arrangements are often more complex than in other EU member states. The current passporting arrangements under the Second Banking Directive allow firms to sidestep at least some of the consumer protection arrangements in the UK.

16. We are particularly concerned about the following aspects of passporting:

- > Host state regulators have little to no influence over the regulation of passporting firms. If home state regulators are not doing their job properly consumers are put at risk. We would like to see a change in EU legislation which shifts the responsibility for regulation of passporting firms from home to host state regulator and which also requires passporting firms to seek full membership of the host state depositor guarantee scheme. Consumers should not again be put into a position where a EEA-member state ignores its legal responsibilities to foreign depositors. We also believe that consumers should not be forced to claim from different compensation schemes but should be able to access their home state compensation scheme for all payouts.
- > Even with a change of regulatory responsibility from home to host state regulator for passporting firms, the host state regulator will still not be in a position to exercise control over the activities of the passporting firm’s parent company and therefore might be unaware of financial difficulties or risky business models endangering the financial future of the passporting firms. We therefore want passporting firms to pre-fund their compensation arrangements in their host states. Alternatively, member states should be required to act as lenders of last resort for their compensation schemes.
- > We also believe that collaboration between national regulators needs to be strengthened. Co-operation on the supervision of larger banking groups is supposedly already taking place but smaller firms like Landsbanki and Kaupthing seem to have slipped past the radar. The UK has a very consolidated retail banking industry and UK consumers rely on foreign banks to drive competition in the market especially for savings products.

They need to be able to rely on a strong supervisory regime that ensures that their deposits are safe.

### **Possible reforms to the remuneration structures prevalent in financial services (1.6)**

17. Please see our previous submission to the Committee dated 13 November 2007.

### **Regulation of highly complex financial products, and the future of the originate to distribute model (1.9)**

18. The lending process can be broken into four main activities:

- 1) Marketing and attracting potential customers.
- 2) Risk assessing whether the consumer can afford the loan and underwriting.
- 3) Loan servicing – managing the relationship with the customer once the loan is made.
- 4) Funding and holding the loan.

19. Over many years the domestic retail, corporate and institutional deposits combined with shareholder capital have formed the bedrock for bank and building society lending. The bank or building society undertook all of the four main activities and held the loan on their balance sheet.

20. However, in recent years some firms entering the market began to specialise in only one or two of the main activities. Increasingly, loans were funded and held by organisations that did not originate them – known as the ‘Originate to distribute’ model. The mechanisms for this were:

- > Whole loan sales between two balance sheet lenders.
- > Whole loan sales from a specialist risk assessor/lender to a balance sheet lender.<sup>65</sup>
- > The bundling of loans into UK Residential Mortgage Backed Securities (RMBS) and covered bonds which were then sold to banks and building societies or to investors and other financial intermediaries.

21. Investor demand driven by a ‘search for yield’ drove increases in the issuance of mortgage backed securities. This activity was also driven by the interests of investment banks which gained substantial revenue from originating the loans, bundling them together into complex financial securities and then trading these

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<sup>65</sup> Such as the arrangement by Bradford and Bingley to purchase mortgages from GMAC and Kensington mortgages.

securities.<sup>66</sup> The easy access to funding before the credit crunch drove the emergence of specialist lenders which relied on the ‘originate and distribute’ business model. It also encouraged retail banks and building societies to diversify their funding models by issuing RMBS or covered bonds and tapping wholesale deposits.

22. Between 2000 and 2007, the total amount outstanding of UK RMBS and covered bonds rose from £13 billion to £257 billion<sup>67</sup>. While the majority of RMBS outstanding at the end of 2007 related to prime mortgages, funding through securitisation and the ‘originate and distribute’ model was relatively much more important for subprime mortgages, and buy-to-let mortgages. Over time lenders took on progressively more credit risk by expanding lending to these sectors alongside loosening requirements for mainstream mortgage products by lending a higher multiple of consumer’s incomes and 95% or even over 100% of a properties value.

We have attempted to list some of the important advantages and disadvantages of the different funding models for consumers.

**Table 1: Advantages and disadvantages of different extremes of models for UK mortgage lending.**

<b>Traditional Balance sheet model</b>	
<b>Advantages</b>	<b>Disadvantages</b>
<ul style="list-style-type: none"> <li>• Tested and understood.</li> <li>• Relationship model with less scope for conflicts of interest and information gaps.</li> <li>• More stable model in a downturn caused by reduced liquidity or the closure of the securitisation markets.</li> </ul>	<ul style="list-style-type: none"> <li>• The capacity to lend is limited by growth in traditional retail and wholesale deposits. Given the low UK savings rate, this could have acted as a significant constraint on lending.</li> <li>• Greater barriers to entry lead to reduced competition and higher prices.</li> <li>• Less degrees of specialisation in the different lending functions could lead to a lack of innovation or efficiency and consequent higher prices. If lenders refuse to deal with mortgage intermediaries then consumers may find it difficult to access independent advice.</li> <li>• Still vulnerable to instability if using short-term wholesale deposits to fund long-term</li> </ul>

<sup>66</sup> This effect can most clearly be seen in the entrance into the UK and US mortgage market of a number of investment banks, including Merrill Lynch, Lehman brothers, Morgan Stanley and Credit Suisse through the takeover, establishment or partnership with specialist lenders.

<sup>67</sup> HM Treasury: The Crosby Report, November 2008, p12. [http://www.hm-treasury.gov.uk/d/pbr08\\_mortgagefinance\\_1010.pdf](http://www.hm-treasury.gov.uk/d/pbr08_mortgagefinance_1010.pdf)

	loans.
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<b>Originate and Distribute model</b>	
<b>Advantages</b>	<b>Disadvantages</b>
<ul style="list-style-type: none"> <li>• More segments of the market being served (because of greater competition and more specialist risk assessment for previously under-served parts of the market).</li> <li>• Improved service at time of mortgage application and servicing over the life of the loan.</li> <li>• Lower funding costs from broadening the sources of capital leading to lower prices for consumers.</li> <li>• Greater efficiency and competition from market entrants leading to lower prices for consumers.</li> <li>• In theory, a vigilant investor base should monitor</li> </ul>	<ul style="list-style-type: none"> <li>• More unstable than the traditional model. Capacity to lend limited by investor demand for securities.</li> <li>• Potential for irresponsible lending. Vulnerable to conflicts of interest if underwriters sacrifice quality to maintain the volume of loans.<sup>68</sup> Remuneration-based incentives may lead to poor risk assessment. Consumers are given loans which are unaffordable.</li> <li>• Previously under-served consumers are vulnerable<sup>69</sup> to swings in the availability of credit caused by the instability of the 'originate and distribute' model. Higher and more volatile prices for consumers will increase the probability of arrears, default and repossession.</li> <li>• Asset prices will be more subject to instability. The volatility in the housing market, at least in part, is caused by the higher price and lack of availability of credit.</li> <li>• Vulnerable to information asymmetries. Lengthening the distance between the funder and the borrower leads to information gaps. Investors relied too much on credit ratings agencies rather than knowing what they were buying.</li> <li>• Rather than being bought by long-term investors most securities, particularly those rated 'AAA' were bought by the banking industry, or by Structured Investment</li> </ul>

<sup>68</sup> See Originate-to-Distribute Model and The Sub-prime Mortgage Crisis, Purnanandam (2008)

<sup>69</sup> The Bank of England has concluded that the cost of credit for credit-impaired consumers or those with high Loan-to-Value ratios has increased significantly more than for prime mortgages and those with low Loan-to-Value ratios.

credit quality.	Vehicles which were inadequately capitalised and had to be absorbed back onto banks balance sheets when the credit crunch started. This led to the instability of institutions which damaged consumer confidence.
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### **The future of the UK mortgage market**

23. It is clear that if the mortgage market in the UK were to revert entirely to the traditional model then there would be a substantial contraction in the availability of mortgages. An entire rejection of the “originate to distribute” model would therefore have significant negative implications for individual consumers and the broader economy. The effective closure of the securitisation market means that in aggregate, lenders will be unable to fund even the current level of mortgage lending outstanding on their books, let alone any new lending.

24. This is highlighted by the Crosby Report<sup>70</sup> which estimates that more than £160 billion of mortgage-backed securities will mature over the period to the end of 2010. Instead of funding new lending, banks will have to direct substantial amounts of funding to refinancing these securities.

25. It is vital for consumers that we avoid a self-fulfilling negative spiral, where higher default rates lead to banks cutting back lending and in turn lower economic activity and consequent higher defaults.

26. The focus must be on how we manage the transition and ensure that the ‘originate and distribute’ model can be made to work better for consumers. The key factor will be whether the model can deliver benefits to consumers such as greater efficiency, access and lower cost while ensuring responsible lending and stability.

27. We have made a number of suggestions below:

- > **Standards for mortgage advice must improve:** While the increased potential for irresponsible lending and conflicts of interest in the ‘originate to distribute’ model demand improved supervision, the evidence suggests that there needs to be a significant improvement in the quality of advice in all sectors of the market. The FSA’s thematic work has identified significant shortcomings in the way firms were monitoring the quality of advice and the affordability of payments.<sup>71</sup> In our mystery shopping, 70% of mortgage advisers failed to do a proper check to determine whether the consumer could afford the repayments.
- > **Ensuring sufficient capital for lending:** This should be the immediate priority for the Government. Options include the provision of Government guarantees as recommended by the Crosby report or the purchase of mortgage backed securities by the Bank of England.
- > **The actions of the nationalised/semi-nationalised banks must contribute to the solution:** It clearly makes no sense for the

<sup>70</sup> HM Treasury: the Crosby Report, November 2008. [http://www.hm-treasury.gov.uk/d/pbr08\\_mortgagefinance\\_1010.pdf](http://www.hm-treasury.gov.uk/d/pbr08_mortgagefinance_1010.pdf)

<sup>71</sup> [http://www.fsa.gov.uk/smallfirms/your\\_firm\\_type/mortgage/quality/index.shtml](http://www.fsa.gov.uk/smallfirms/your_firm_type/mortgage/quality/index.shtml)

nationalised/semi-nationalised banks to be leading the contraction in the mortgage market. As we noted in our previous evidence to the Committee's inquiry into the nationalisation of Northern Rock and Bradford & Bingley (November 2007), the rapid shrinkage of Northern Rock's mortgage business is in stark contrast to the Government's intention to maintain the availability of lending. In these circumstances, the Government may have to accept a longer timescale before the nationalised/semi nationalised lenders are able to repay their loans from the Bank of England or capital from the Treasury. This may require a review of the competitive framework and management incentives for these institutions as well as appropriate management by UKFI.

- > **Making the 'originate and distribute' model work for consumers:** In the longer term it will require a more diversified and involved investor base, greater transparency and standardisation of mortgage-backed securities and other financial instruments, together with reform of credit-rating agencies.

### **The nationalisation of Northern Rock and Bradford & Bingley (2.2)**

28. Please see our previous submission to the Committee dated 11 November 2007.

### **The role of UKFI and its relationship with the part-nationalised banks (2.5)**

29. The Government has stated that the part-nationalised banks will be managed "at arms length" by UK Financial Investments (UKFI) "on a commercial basis". While recognising the importance of securing adequate returns for taxpayers from the substantial public investment in these banks, the nationalised and part-nationalised institutions have a responsibility to lead the way in terms of treating customers fairly. The public will not understand why, given the massive levels of support they have provided to the part-nationalised banks, they should be able to pursue policies that may be detrimental to the consumer interest.

30. The significant public interest in the way in which the nationalised and part-nationalised banks are managed should be recognised within UKFI itself. We want to see public interest representation on the UKFI board, including the appointment of an explicit consumer champion. As with our proposal for consumer input to the National Economic Council, this would allow the experiences of consumers to be fed into decision-making at the highest level. It would also help challenge the kind of group thinking that appeared to exist within the banking industry prior to the current crisis.

### **The role of banks in receipt of public investment in fulfilling the Government's aspirations for assisting customers, and small businesses, in financial difficulty (3.1)**

31. The substantial amounts of public money that have been put into the banking sector over the last few months appear to have brought a degree of stability to the sector. However, one of the outcomes of this investment has been to develop considerable conflicts of interest in the objectives of many of the UK's largest financial institutions. On one the hand they remain commercial enterprises that have a primary duty to shareholders (including, in many cases, the taxpayer). However, the scale of the injection of public money also means that they should now have a specific duty to act in the wider public interest. Nowhere is this more important than in the way they treat customers in financial difficulty. As we enter difficult economic times, we want to see excellent practice in this area from all financial institutions but we believe that it is important for the institutions that have received public investment to lead the way.

32. We appreciate that in the current climate these institutions have contradictory demands placed upon them. On the one hand we want them to serve consumer needs by advancing affordable credit and passing on the benefits of base rate cuts to consumers but on the other hand we want them to rebuild their balance sheets, repay the taxpayer investment and also increase their contributions to the financial compensation scheme. While recognising that there will be an adjustment in the cost and availability of credit, it would be very damaging to go from 'feast to famine'.

33. The Government, along with much of the industry, has already taken steps to address the likely impacts of the contraction in availability of credit. The extension to the Income Support for Mortgage Interest (ISMI), the mortgage repossession pre-action protocol; the Mortgage Rescue scheme (although we think it should be made compulsory and extended to all secured lenders), and the agreement by lenders to wait at least three months before beginning proceedings are all welcome developments. However, as time progresses it may be necessary to go beyond even these steps, especially if the situation markedly worsens. For example, the FSA needs to increase fines and naming and shaming of companies that are not treating customers in mortgage arrears fairly.

34. We have specific concerns that because of the terms in the securitisation agreements borrowers whose mortgages have been securitised and who fall into arrears may be treated less sympathetically than borrowers whose mortgages are held on balance sheet by a balance sheet lender. They may also be restricted from participating in Government rescue schemes. The third party service providers for these loans are bound by FSA rules and the requirement to treat customers fairly. The FSA's thematic work on mortgage arrears found that there were particular problems with specialist lenders and that more widely, lenders did not exercise sufficient oversight of third parties contracted to carry out mortgage arrears and repossessions handling activities on their behalf. We believe that any review by the FSA and the Government should pay particular attention to this issue.

**The importance of retail banking as a ‘utility’, and whether retail banks should be separate from other activities such as investment banking and insurance provision (3.2)**

35. Which? believes basic retail banking does constitute a utility. Without access, it is very difficult, if not impossible, for consumers to participate in economic life.

36. There are differing views as to the definition of retail banking as a utility, which is also often referred to as the “narrow banking model”. The main differentiation is between commentators who define narrow banking as deposit taking activities only and those that include the provision of finance to individuals and small businesses. For the purposes of this response we will use the former definition.

37. Arguments commonly brought in favour of “narrow banking” are:

- > It makes retail banks infallible and secures the payment system;
- > It avoids conflicts of interest created by the granting of credit and the use of credit by the same institution;
- > It protects retail banks from the fallout of risky and speculative activities which threaten the integrity of deposits. Deposit insurance therefore becomes unnecessary, which also deals with the issue of moral hazard created by an ex-post insurance system; and
- > The current model allows retail banks to use their deposit base – on which there is an implicit government guarantee – as collateral for their speculative trading<sup>72</sup>.

38. Arguments brought against “narrow banking” include<sup>73</sup>:

- > Deregulated financial markets have created products where the distinctions between loans, securities, and deposits are not well drawn.
- > A UK only narrow banking model would be undermined by international competition;
- > Conflicts of interest can be prevented by regulating banks, and by separating the lending and credit functions through forming distinctly separate subsidiaries of financial firms;
- > The business model for “narrow banks” leaves little to no incentive for effective competition and could lead to inefficiency and wastefulness;
- > Interest rates payable on deposits with narrow banks would be negligible – the interest rate of safe government bonds minus the cost of running the institution<sup>74</sup>. It would therefore not be in the interest of small savers who want their savings to be safe but also want a decent return on their savings; and

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<sup>72</sup> John Kay: Making banks boring again. Prospect Magazine Issue 154, January 2009.

<sup>73</sup> <http://digital.library.unt.edu/govdocs/crs/permalink/meta-crs-9065:1>

<sup>74</sup> Maverecon - Willem Buiters's Blog, 22/09/08:

<http://maverecon.blogspot.com/2007/09/would-narrow-banking-prevent-another.html>

- > Separation of retail and investment banking could lead to a further weakening of the regulatory and supervisory regime for investment banks.

39. Our focus when looking at “narrow banking” is to look at the desired outcome for consumers:

- > Protection of the continued functionality of the payment system.
- > Protection of consumers’ deposits.
- > Ongoing ability to access liquidity in the form of short-term credit.

40. A separation of retail banking from investment banking and insurance provision could potentially achieve some of these requirements. However, the “narrow banking” debate only focuses on consumer protection in terms of their retail banking activities. In reality, consumers’ financial wellbeing is affected by the banking crisis and the related economic crisis in a number of ways:

- > Safety of their employment.
- > Safety of their retirement savings.
- > Access to low-risk financial products that offer a return above inflation.
- > Access to both secured and unsecured credit.

41. We therefore believe that it is necessary to look beyond the issue of “narrow banking” to ways of protecting consumers. Our ideal outcome is to achieve a situation where consumers can be confident that their deposits in particular and the banking system in general are safe in an environment that allows enterprises to prosper. In our view, this can only be achieved by making the regulatory regime for both retail and investment banking more effective and by introducing stronger questioning and enforcement into the supervisory process.

42. The current review of retail regulation of banking by the FSA offers the opportunity to improve consumer outcomes in the way the sector treats their customers. However, the FSA needs to demonstrate that if it is handling conduct of business regulation it is able to effectively intervene in emerging problems. This is not a characteristic of the FSA with which we are familiar. Any change in retail regulation must be demonstrably advantageous to the consumer.

### **The competition impact of further consolidation within the retail financial services sector (3.3)**

43. We have long-standing concerns about the lack of effective competition in the retail banking sector which has been dominated by the ‘Big Five’ of Lloyds TSB, HSBC, Barclays, RBS/Natwest and HBoS. Since the start of the banking crisis there have been a number of significant changes in the market structure of the banking sector that we believe are likely to have further weakened competitive pressures. These include: the proposed merger of Lloyds TSB and HBoS; the nationalisation of Northern Rock and Bradford & Bingley’s mortgage book; the takeover of Alliance & Leicester and the remainder of Bradford & Bingley by Santander; and numerous smaller mergers in the building society sector.

44. During this time of financial upheaval it must not be forgotten that any concentration of market share created now will have a long-term impact upon market structure and conditions of entry. The loss of consumer confidence in the sector is also likely to further undermine the ability and willingness of consumers to drive competition.

### **Competition Problems in the Banking Sector**

45. There are two features of retail banking services – the business model employed by banks and the relative weakness of consumers – that we believe play a significant role in retarding effective competition. First, the business model for high street banks relies on the opportunity to cross-sell a range of financial products. This in turn facilitates cross-subsidy and loss-leading, with banks operating their retail business on a portfolio basis to ensure overall profitability.<sup>75</sup> Personal Current Accounts and, to a lesser extent mortgages, are key ‘gateway’ products. Second, consumers of financial services face significant challenges, particularly with respect to financial capability, that affect their ability to make informed decisions between competing financial products. Consumers may also display many behavioural characteristics that lead to suboptimal choices.

46. Banks have taken full advantage of the lack of competition and consumer understanding in this sector. Over the past decade we have seen numerous problems in the financial services industry that have manifested themselves as a result of a lack of effective competition. We have embarked on a series of campaigns over the past decade to address such problems and ensure that consumers receive a fair deal. Among the issues we have sought to address are charging for ATMs, unfair overdraft charges and mis-selling of Payment Protection Insurance.

### **Lloyds TSB/HBoS Merger**

47. We are particularly concerned by the competition implications of the proposed merger of Lloyds TSB and HBoS. We recognise that there are exceptional circumstances which mean the merger may be necessary. However it is important to take into account the long-term impact on market structure that will result from the creation of this ‘super bank’. If the two companies retain their 2007 market shares the new institution would stand head and shoulders above the rest of the banking sector controlling 30% of the current account market<sup>76</sup>, 28% of mortgages<sup>77</sup>, 25% of savings<sup>78</sup> and 21% of personal loans<sup>79</sup>.

48. We are concerned that an institution of this size will be even less responsive to competitive pressures and could as a result cause consumer harm. In the PCA

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<sup>75</sup> The OFT’s market study into PCAs notes that banks share common costs across a range of activities, and in practice many banks do not apparently track profitability by product line (Paragraph 2.35 – 2.41. Personal current accounts in the UK, July 2008, OFT).

<sup>76</sup> Mintel Current Account report 2008

<sup>77</sup> CML research/thedata ltd/Mintel

<sup>78</sup> GfK NOP/Mintel

<sup>79</sup> GfK NOP/Mintel

market, HBoS has been a strong driver of price competition, raising awareness amongst consumers of the poor levels of interest generally offered by high-street banks. It is therefore particularly damaging to competition that the market leader in personal current accounts (Lloyds TSB had 19% market share in 2007<sup>80</sup>) should be absorbing this key rival.

49. Meanwhile, although current competitive conditions in the mortgage market are far from 'normal', the prospect of creating a single lender with nearly 30 per cent of the overall market means that there are also doubts about the extent to which the new institution will feel sufficient pressure to offer competitive deals in the future.

50. In the normal course of events, Which? would have demanded that this proposed merger be referred to the Competition Commission for further investigation. In this instance, whilst we acknowledge the need to preserve financial stability we have called for specific measures, such as ongoing scrutiny by the OFT, to be taken to ensure that consumers are not adversely affected.

### **Wider Competitive Concerns**

51. In addition to the proposed merger of Lloyds TSB and HBoS, some of the other changes to the structure of the market are likely to lead to a lessening of competitive pressure. This is particularly likely in the mortgage market following the demise of much of the 'competitive fringe' of demutualised building societies and other specialist lenders. These problems are likely to be accentuated by the closure of the securitisation markets as highlighted in the Crosby Report.<sup>81</sup>

52. Until recently, mortgage lending has been considered relatively competitive, with consumers appearing more willing and able to shop-around for better deals, triggered by events such as end of a fixed-deal. Which? survey results indicate almost 60 per cent of people have changed mortgage at least once.<sup>82</sup> The price of mortgage deals, including fees, was the primary factor for selecting provider, although brand reputation was the principal secondary factor. However, mortgage lending, and the range of products available, has seen a significant contraction. Consumers, who already face difficulties engaging in the market, may also be reluctant or unable to switch if they depend upon an existing relationship to ensure access to credit under current circumstances.

### **The product pricing of credit facilities, including mortgages, credit cards, store cards and small business loans (3.4)**

#### **Mortgages**

53. We note the following:

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<sup>80</sup> Mintel Current Account report 2008

<sup>81</sup> Sir James Crosby, '*Mortgage Finance, Final Report and Recommendations*', November 2008

<sup>82</sup> 'Insight Report: 70043 Mortgage Satisfaction 2008', Which? A survey of Which? members conducted in July 2008, with 2104 responses.

- > The failure to pass on the falls in the base rate and LIBOR, combined with increasing arrangement fees means that the cost of mortgages relative to the base rate is at a 13-year high.
- > The recent falls in LIBOR and the action banks have taken to cut savings rates have meant that banks have substantially increased their margins.
- > Mortgages with a greater than 90% LTV have been withdrawn almost entirely from the UK market.

### ***Variable Rates***

54. The chart below shows the spread of the main variable mortgage rates above the Bank of England base rate. It shows that up until the middle of 2007, the average rate for a 2-year discounted deal (even for those with high Loan-to-Value) was close to the Bank of England base rate. Lenders Standard Variable Rates (SVRs) which consumers were moved onto once their short-term deal expired were typically between 1.5-2 percentage points above the base rate. This led to significant switching activity as consumers were willing and able to shop around for better mortgages, triggered by the end of a short term deal. A wide variety of mortgages were available, offering consumers the ability to borrow 95% or even 100% of the properties value.

55. This all changed in the latter half of 2007 and 2008. The difficulty in securing funding for mortgages due to the closure of the securitisation markets led to the exit of many specialist lenders.<sup>83</sup> It has been estimated that over the next two years in excess of £160 billion of redemptions of existing mortgage backed securities will need to be refinanced. These factors, together with the nationalisation of two of the top ten lenders<sup>84</sup> and the consolidation or takeover of several other major lenders,<sup>85</sup> will lead to a significant contraction in mortgage availability.

56. Mortgage rates rose steeply and mortgages for those with high Loan-to-Values were withdrawn from the market. There was a significant decrease in the number of products available. Lenders have substantially increased their margins by not passing on cuts in the Bank of England base rate in full to consumers. New tracker mortgages are now only available at significantly higher margins over base rate. The result is that the spreads between the base rate and variable mortgage rates are at their highest levels in 13 years.

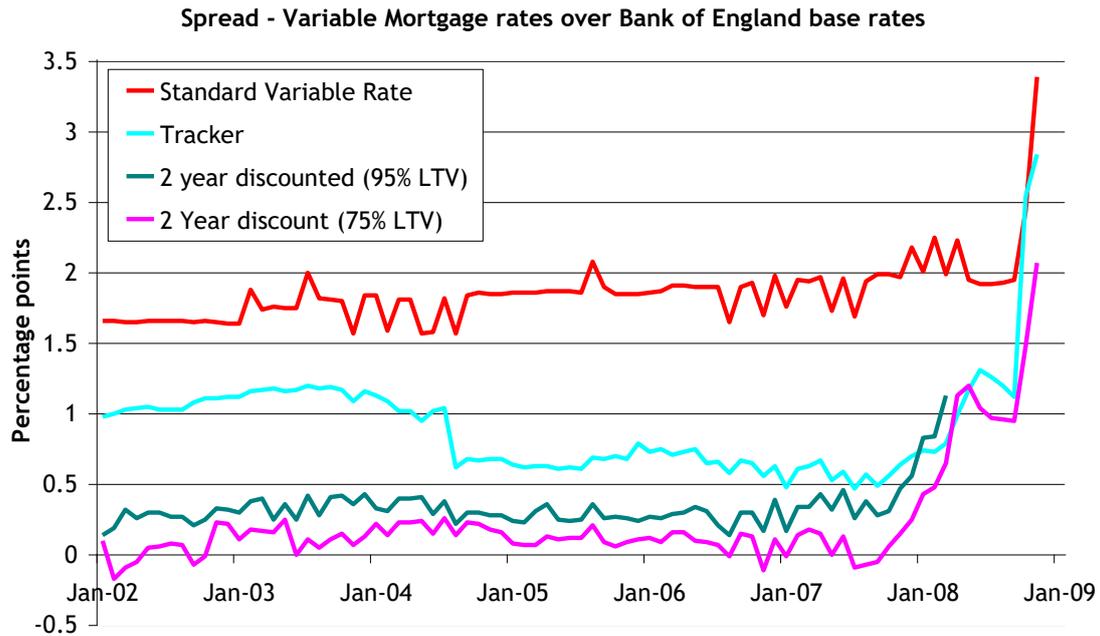
### **Chart 1: Spread between variable mortgage rates and the Bank of England base rate**

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<sup>83</sup> Whereas there were between 10 and 12 specialist lenders a year ago, industry estimates suggest that no more than 3 are now accepting new business. See Crosby Review, page 31

<sup>84</sup> Bradford and Bingley and Northern Rock

<sup>85</sup> Alliance and Leicester was acquired by Santander and merged with Abbey; Nationwide merged with Cheshire and Derbyshire Building Societies; The proposed merger of Lloyds TSB and HBOS.



Source: Bank of England

### ***Fixed rates***

57. Fixed rate mortgages would typically be priced off 2-year swap rates. The significant falls in 2-year swap rates over the last 18 months have not yet been reflected in reductions in 2-year fixed rates for consumers. Moneyfacts found that despite a 2.61% drop in the 2-year swap rate since 1 October 2008, the average two-year fixed rate had only dropped by 0.71%. The gap between the two-year swap rate and the average two-year fixed mortgage rate had increased from 1.12% in December 2007 to 2.92% in December 2008.<sup>86</sup>

### ***Standard Variable Rates***

58. The withdrawal of many competitive mortgages for consumers requiring a greater than 75% LTV and the almost complete withdrawal of mortgages with a 90% LTV will mean that the only choice for many consumers coming to the end of their short-term deal will be to move onto the Standard Variable Rate. To help cushion consumers in the current period, reducing SVRs in line with base rates is a pragmatic consumer focused solution. We expect the banks that have received taxpayer funds to lead the way.

59. In the five years leading up to the start of 2007, the average SVR was just 1.78% above the base rate. Following the failure of many lenders to pass on the full reduction in the SVR, the average for 14 major lenders was 2.74% above the base rate.

<sup>86</sup>

<http://www.moneyfactsgroup.co.uk/press/pressreleases/displaypressrelease.asp?id=642>

60. The table below shows the extent to which individual banks and building societies have passed on the base rate cuts since October. The table shows that the average cumulative reduction in the SVRs for these institutions has been 2.30%. This failure to pass on the full base rate cut means that an average consumer with a £175,000 repayment mortgage on the Standard Variable Rate will be paying an extra £830 over the next year. Only Lloyds TSB/Cheltenham and Gloucester have passed on the full 3% cut in the base rate since October.

**Table 2: SVRs – 1<sup>st</sup> October 2008 to 5<sup>th</sup> January 2009**

Institution	SVR - 1st October	SVR - After October IR Cut	SVR - After November IR Cut	SVR - After December IR Cut	Cumulative Δ SVRs
Abbey	7.09	6.94	5.44	4.94	2.15
Alliance & Leicester	7.19	6.94	5.84	5.34	1.85
Barclays	7.14	6.64	6.64	5.49	1.65
BoS	7.35	6.85	5.35	4.84	2.51
Bradford and Bingley	7.09	6.64	5.59	4.84	2.7
Cheltenham & Gloucester	7.00	6.50	5.00	4.00	3
Halifax	7.00	6.50	5.00	4.75	2.25
HSBC	6.25	6.25	5.44	4.44	1.81
Lloyds TSB	7.00	6.50	5.00	4.00	3
Nationwide	6.49	6.19	4.69	4.00	2.49
Natwest	7.19	6.69	5.19	4.44	2.75
Northern Rock	7.49	7.34	5.84	5.34	2.15
RBS	7.19	6.69	5.19	4.44	2.75
Woolwich	7.14	6.64	6.64	5.49	1.65
<b>Average SVR</b>	<b>7.04</b>	<b>6.67</b>	<b>5.49</b>	<b>4.74</b>	<b>2.30</b>

Source: Moneyfacts<sup>87</sup>.

*How many households are stuck with their existing lender?*

<sup>87</sup> Data is taken from *Moneyfacts Datascreen*, through the Which? subscription.

61. The table below shows the number of consumers who have a Loan-to-Value of greater than 90% and would therefore struggle to obtain a new deal given current conditions in the market. If house prices fell a further 15% from their levels of September 2008, around 1.5 million households would have a Loan-to-Value of greater than 90% and would not be able to switch away from their current lender.

**Table 3: Number of households with high Loan-to-Value mortgages given further falls in house prices (millions of households)**

Loan-to-Value	House price levels			
	Sep/Oct 2008	Further falls of		
		5%	10%	15%
Less than 60%	8.0	7.8	7.4	7.2
60%—70%	1.52	1.30	1.09	0.79
70%—80%	0.81	1.07	1.02	1.30
80%—90%	0.76	0.56	0.83	1.01
90%—100%	0.36	0.58	0.74	0.24
100%+ (Negative equity)	0.35	0.55	0.71	1.26
Total with greater than 90%	<b>0.71</b>	<b>1.13</b>	<b>1.45</b>	<b>1.5</b>

Source: Which? calculations based on Bank of England data, Financial Stability Report, October 2008, chart 2.3

### ***Mortgage arrangement fees***

62. The average mortgage arrangement fee was just over £1,200 in December 2008 and has increased by £384 (46%) over the last year. The longer term trend has been one of substantially increasing fees, which have almost quadrupled over the past five years.<sup>88</sup>

**Table 4: Average Mortgage Arrangement Fees**

Date	Average Fee
1 <sup>st</sup> Nov 2007	£827
1 <sup>st</sup> May 2008	£936
1 <sup>st</sup> Jul 2008	£1,001
1 <sup>st</sup> Aug 2008	£1,058
1 <sup>st</sup> Sept 2008	£1,104

<sup>88</sup> The average arrangement fee in February 2004 was £320, HM Treasury, The Mortgage Market: Taking a Longer-term view, David Miles, Final report, para 5.26

1 <sup>st</sup> Oct 2008	£1,029
1 <sup>st</sup> Nov 2008	£1,235
1 <sup>st</sup> Dec 2008	£1,211

**Source:** Moneyfacts<sup>89</sup>.

## **LIBOR / Savings rates**

63. Banks and their representatives have claimed that they are unable to pass on base rate cuts to consumers due to the fact that the costs to the banks of raising money in the wholesale markets is still high. However, LIBOR has fallen substantially since the peak of the credit crisis in October. On 1<sup>st</sup> October LIBOR was 6.31%, when the base rate was 5%. After the cuts in the base rate, LIBOR has fallen to 2.64%; a fall of 3.67%.<sup>90</sup>

64. Despite talking about the need to protect savers, banks continue to pass on cuts in the base rate to savers. 92% of banks passed on November's 1.5% cut in full (or more) to their savings rates.<sup>91</sup> Full results from the December 1% cut are not yet available. However, some banks have already moved to widen margins. Despite only cutting its Standard Variable rate by 0.25%, on 1 January, Halifax cut a range of savings rates, many by the full 1%. It is now paying just 0.15% on its variable rate ISA, for amounts between £3,000 and £12,000. To get a good deal in the savings market, consumers will need to regularly review their products and be willing to switch.

## **Unsecured credit**

### ***Credit cards***

65. Despite cuts in the base rate, there has been a small increase in average interest rates on credit cards of around 1 percentage point in the last year. This comes alongside substantial increases by some cards on the interest rate for cash advances, sometimes to in excess of 25% APR, and increased fees for cash withdrawals, balance transfers and foreign exchange transactions alongside reductions in the length of interest free periods.<sup>92</sup>

### ***Personal loans***

66. Unsecured personal loan rates have also increased, both in absolute terms and relative to the base rate but for larger loans (£10,000) actual loan rates and spreads remain lower than five years ago. However, we see the trend of rising

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<sup>89</sup> Moneyfacts (2008). 'Which? Advice: Mortgage Fees', pub: Which? online, accessed at <http://www.which.co.uk/advice/mortgage-fees/arrangement-fees/index.jsp>

<sup>90</sup> 3-month LIBOR, Source: BBA

<sup>91</sup>

<http://www.moneyfactsgroup.co.uk/press/pressreleases/displaypressrelease.asp?id=638>

<sup>92</sup>

<http://www.moneyfactsgroup.co.uk/press/pressreleases/displaypressrelease.asp?id=634>

loan rates continuing<sup>93</sup> and there is evidence that the cost of smaller value loans has been increasing more steeply. The majority of personal loans are at fixed rates for the life of the loan so once the loan has been granted there should be no change to the interest rate. However, if the loan rate is variable (which might be the case with secured loans) we would expect firms to adopt similar principles to those outlined for credit card firms by BERR, for the OFT to review variation terms in the contract to check they are fair, and for falls in the Bank of England base rate to be reflected in the price paid by consumers.

### ***Overdrafts***

67. The average interest rate on an authorised overdraft is now 18%, a rise of over 3 percentage points from 15% in January 2005. Falling base rates have not yet had any effect on the overdraft interest rate and the spread between overdraft rates and the base rate is at a 10-year high, meaning that relative to the base rate, borrowing through an overdraft has never been more expensive. It has been reported that HBoS will move to a system of charging daily fees of £1 per day for overdrafts up to £2,500.<sup>94</sup> This could mean significant increases in cost for those consumers who are overdrawn by a small amount for part of the month. For small overdrafts, this daily charge results in a very high APR.

**Table 5: APR equivalent for £1 daily charge for authorised overdrafts at Halifax**

Overdraft size	Interest rate (APR)
£250	146.0%
£500	73.0%
£750	48.7%
£1000	36.5%
£1500	24.3%
£2000	18.3%

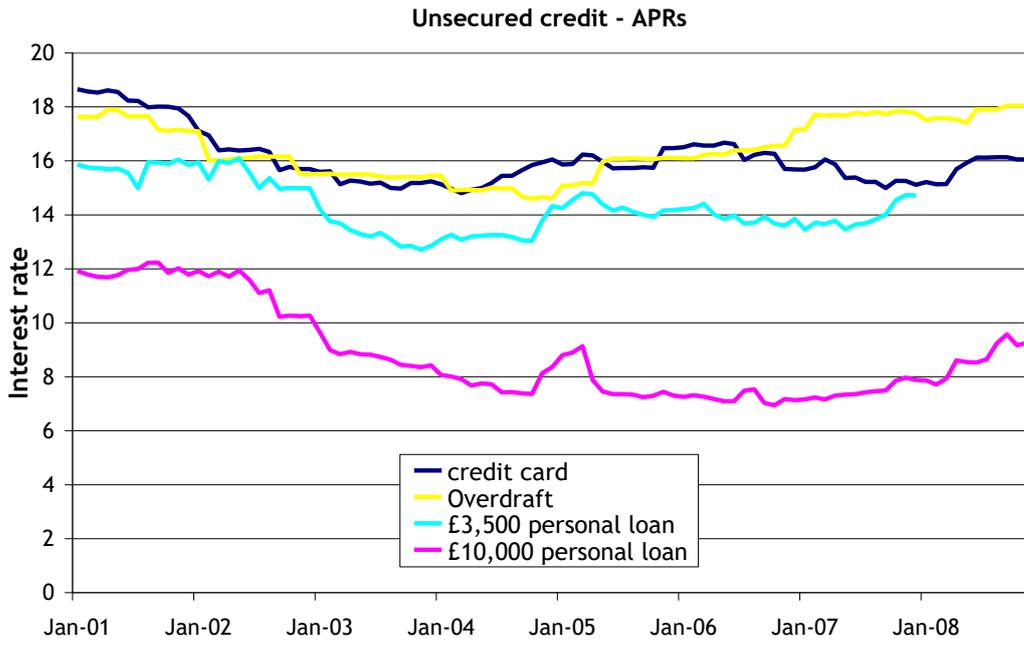
### ***Store cards***

68. Which? advises consumers to avoid borrowing on a store card as the interest rate is significantly higher than a comparable credit card.

### **Chart 2: Unsecured credit (APRs)**

<sup>93</sup> The Bank of England credit conditions survey (Q4) found that lenders expected to increase spreads on other unsecured borrowing including personal loans over the next three months.

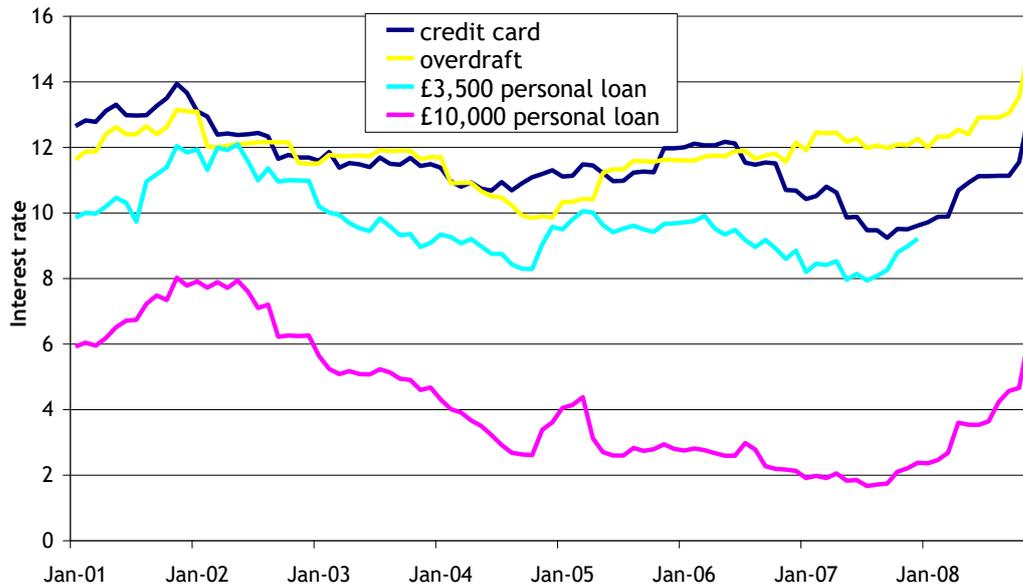
<sup>94</sup> <http://news.bbc.co.uk/1/hi/business/7780551.stm>



Source: Bank of England

**Chart 3: Spread – Unsecured credit lending rates over Bank of England base rate**

Unsecured credit - Spread between lending rates and Bank of England base rate



Source: Bank of England

### Changes to interest rates on credit cards

69. In recent months, the focus has been on credit card companies which have dramatically increased interest rates for some consumers. It has been reported that in some cases the scale of the change can be substantial, for example from 19% APR to 29% APR, and can be applied to existing debt. The Financial Ombudsman has indicated that while the complaints it has received are comparatively limited compared to the number of cards in issue, there are indications that the practice has become widespread and covers a “wide range of mainstream card providers”.<sup>95</sup>

70. There is currently no transparency about which credit card firms have been exercising this practice. We have not seen any indication that card providers have been informing consumers that they may increase interest rates by up to 10% under these terms. Despite reports that the practice of these “penalty rates” is apparently widespread, the industry has failed to include information in the Summary Box.

71. It is important banks are not able to exploit their captive customers. In the light of reduced credit availability, even if borrowers receive notice of the increase, they may be unable to switch to another card or credit product. Dramatically increasing interest rates for borrowers in financial difficulties is irresponsible and unfair.

<sup>95</sup> [http://www.wider-implications.info/case\\_studies/ombudsman-service-risk-based-step-changes.pdf](http://www.wider-implications.info/case_studies/ombudsman-service-risk-based-step-changes.pdf)

72. Which? also questions whether such changes to the applicable interest rate is compliant with the rules on unfair contract terms<sup>96</sup>, particularly:

- > Whether credit card providers can materially alter a contract without an objectively justifiable reason;
- > Whether credit card providers can increase the cost of credit for existing debt, especially where there is no more than a mere theoretical right to terminate the contract; and
- > Whether consumers should be penalised in the event the credit card provider considers it has entered a 'bad bargain'.

73. In addition, there is a serious question of whether the credit card providers are complying with their obligations under the Consumer Protection from Unfair Trading Regulations 2008 (CPRs) if they are not informing the customer at the outset that the charge for credit could change significantly with little notice (particularly where such an increase applies to existing debt).

74. We welcome the new code of conduct agreed by BERR with the credit card companies but believe that it does not go far enough. It is important that adherence to this code is robustly monitored by the OFT. We believe the OFT, FSA, Banking Code Standards Board and Financial Ombudsman must take a robust approach to firms altering interest rates unfairly. There needs to be a full and transparent review as to whether credit card companies have been breaching or continue to breach the Unfair Terms in Consumer Contracts Regulations<sup>97</sup>, the CPRs and their obligations to treat customers fairly. Such a review could examine factors including:

75. The terms in the contract:

- > To what extent does the contract provide for material changes to the contract e.g. variation to the interest rates and charges?
- > Must there be more than a theoretical right to terminate a contract upon a unilateral change by the supplier to ensure the change and/or the right to introduce a material change is fair and reasonable?
- > Is it fair to apply the change in interest rate to existing debt as well as new debt?
- > To what extent were these terms made clear when the consumer took out the contract or have they been changed overtime?
- > Is the change in interest rates due to a 'valid reason'? Are particular 'valid reasons' specified in the contract terms?

76. If the credit card firm is saying that the change in interest rate is based on a consumer's financial position:

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<sup>96</sup> There are also questions about whether banks are increasing interest rates to penalise customers to get round the presumed cap on default charges that resulted from the OFT investigation into the fairness of credit card default charges.

<sup>97</sup> <http://www.opsi.gov.uk/si/si1999/19992083.htm>

- > On what basis is the firm making this assessment e.g. by reference only to the contract in question, or on the basis of a credit scoring?
- > Has the basis for the assessment been provided to the consumer?
- > Has a consumer's financial position actually changed?
- > Has the consumer been provided with a chance to challenge a finding that his financial position has changed and/or the opportunity to correct defective information held by credit reference agencies.

### **The protection of UK citizens investing funds in non-UK jurisdictions (3.5)**

77. We differentiate between consumers who invest funds with financial institutions that passport into the UK and are therefore paying tax on their investments in the UK and those that invest in non-UK jurisdiction that allow them to avoid their UK tax liability. In our view, the UK taxpayer cannot be expected to underwrite investment overseas when individuals have not paid the UK tax that funds the relevant protection.

78. However, we do believe that the lack of protection or reduced level of protection should be made clear to consumers in any financial promotions used to advertise such products as well as any related explanatory literature. Financial advisers who advise customers to invest in non-UK jurisdictions also need to be responsible for explaining the reduced protection to consumers as well as taking the reduced level of protection and the therefore higher risk profile of the investment into account when assessing suitability of a product for a consumer.

### **The impact of deposit protection on both consumers and competition (3.6)**

79. Which? considers depositor protection to be one of the cornerstones of the current UK banking model. Without a well-functioning scheme consumers will lose confidence in the banking system. The 'run on the Rock' last year underlined the importance of depositor protection and also threw up the question if the current system is adequate and achieves what it sets out to do.

80. We submitted a response to the Committee's inquiry in to the Banking Reform in July 2008 in which we set out our concerns about the Financial Services Compensation Scheme and refer you to this submission for further details.

81. We do not have any issues with the way the FSCS is run and believe that the administration of payouts for customers of financial institutions that have been declared in default has generally been quite effective. However, we believe that the speed of payouts has to be increased significantly and that the current proposal to reduce the payout time to 7 days is an absolute minimum and that every effort should be made to achieve a payout period of 3 days or less.

### **The impact of the banking crisis on consumer confidence in financial institutions (3.8)**

82. Consumer confidence in the banking sector is crucial to ensure that there is not a flight of money away from any company in the event of rumours, founded or unfounded, about the stability of that company. The Northern Rock crisis indicated what can happen in the event of a particular problem. Equally the entire system is based on a premise that funds deposited will be safe and secure. The core of consumer confidence is that the utility functions of the banking system are guaranteed against the shocks of both systemic failure and individual company failure.

83. Traditionally consumers have expressed high levels of trust and confidence in the banking sector. This trust appears to be instrumental i.e. a belief that money under the control of a bank will be safe and personal data held by a bank will be secure. However this confidence is not carried over into what might be described as emotional trust. The view of consumers is frequently that the bank will not act primarily in the interest of the consumer.

84. The question to consider may be whether the recent financial crisis has challenged the traditional instrumental trust. It may be that the prompt action of the Government to act as the guarantor of all deposits has in effect protected the consumer to the extent that they feel safe in the knowledge that taxpayers' money will reimburse them for a company failure.

85. The work of the Financial Services Research Forum at the University of Nottingham reflects this in their Trust Index report of June 2008<sup>98</sup>, "*System trust appears to be relatively high compared to the other aggregate measures of trust suggesting that consumers have reasonable levels of confidence about the effectiveness of the financial system in providing them with appropriate degrees of protection. This may be relatively unsurprising in the light of Government intervention in relation to the Northern Rock crisis.*" This research work was conducted prior to the height of the banking crisis.

86. Research by Which? in mid October 2008<sup>99</sup> found that consumers held banks most responsible for the crisis in the banking system. 67 per cent of people in an omnibus survey cited the banks as responsible for causing the current crisis. 81 per cent of people also think the banking system needs to change to ensure that the current crisis is not repeated.

87. However confidence in the banking sector is not simply a result of the recent crisis. Recent consumer experiences with, and knowledge of, unfair charging, misselling of financial products, and excessive and unwarranted bonuses have all undermined the sector in the eyes of consumers. While the Committee may reasonably wish to view the issue of confidence purely in terms of the recent banking crisis consumers are unlikely to segregate this occurrence from their perceptions of the way that the sector behaves generally. Equally in future analysis of consumer attitudes it may become increasingly difficult to disentangle confidence in the banking sector from confidence in the economic outlook for the UK. Perceptions of wellbeing and trust may not be easily

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<sup>98</sup> The Financial Services Trust Index, Professor Christine Ennew, page 3.

<sup>99</sup> Which? banking crisis report, October 2008. 1001 GB adults were interviewed online on 16 & 17 October 2008.

segregated so as to accurately apportion concerns simply to the functioning of the banking system.

88. In terms of repairing consumer confidence in the system as a whole there are four questions Which? considers worth consideration and which are likely to contribute to the development and maintenance of consumer confidence:

- > **What do consumers know about the banking system?** Information must be provided in an easily understood manner that allows appropriate decision making and levels of personal responsibility to be exercised. This is important for example in terms of the depositor protection scheme.
- > **What is the time and effort required to be part of the banking system?** Consumers need to be able to trust the system without requiring to carry out huge levels of due diligence on simple products provided by High Street companies. This is where regulators must ensure that they carry out that role in proxy for the consumer creating a safe and simple banking system.
- > **Is the banking system fair?** While the system must provide a commercial return for the banking sector, the experience of the consumer needs to be one where they consider they are receiving fair and honest treatment. Pricing needs to reflect that as much as customer service and elimination of unfair contract terms if confidence is to be maintained.
- > **Is there appropriate control over the banking system?** Consumers need to be clear that the regulatory function is managing risk so as to protect the consumer from the loss of their money within the known risk parameters and that through supervision and enforcement unnecessary risk, fraudulent activities and misselling are dealt with in a robust fashion. Government needs to ensure that this is the case and conflicts of interest are recognised and controlled.

January 2009

## **Memorandum from Pensions & Investment Research Consultants Ltd (PIRC)**

### **Introduction**

Pensions & Investment Research Consultants Ltd (PIRC) has been an independent adviser to pension funds and other institutional investors for over 20 years. PIRC's clients have combined assets in excess of £1.5 trillion and include some of the largest pension funds, investment management companies and insurance companies in the UK and overseas. Together, they comprise a diverse group of institutional investors with long-term liabilities and broad fiduciary duties.

PIRC undertakes company research on corporate governance and corporate social responsibility issues at public companies, and provides advice to clients on proxy voting strategies and other active shareholder initiatives. Our comments are based on two decades of practical experience, which inform our views on the strengths and weaknesses of disclosures, governance structures, and the interaction of statute, regulation and codes of practice.

We have only commented on those areas of the consultation where we have particular views and expertise.

### **The role and responsibility of bank boards**

Before responding to the questions that the committee has set, we would urge that consideration is given to the role and responsibility of the boards of banks. Too much commentary on the banking crisis has overlooked or underplayed the primary responsibility that the boards of banks have for their own failures. Whilst it is of course right to consider the role of regulators and central banks, the board members of the banks that have run into difficulties must take their full responsibility too. They approved the business strategies and products that have caused such damage after all. Therefore we urge the committee to consider the role of boards.

PIRC will also be looking at the role of the directors of the banks that have run into serious difficulties. We believe that they have failed in their role as stewards of major financial institutions, and as such this will influence our analysis of their directorships of other companies. This analysis will be made available to the committee in due course.

#### **1.1 The role of auditors in the banking crisis, and whether any reform to that role is desirable.**

For PIRC, the key principle is that the audit should be perceived to be a wholly independent process. This depends on independence being beyond reasonable and informed challenge, as opposed to being simply an arguable case. The independence of the auditor is of paramount importance to shareholders, both in

respect of individual companies and in terms of audit's public policy function of ensuring investor confidence in financial reporting. Although the auditing profession has long had ethical guidance on objectivity, this has not been sufficient to prevent significant public and regulatory concerns.

During the financial crisis, there has been some speculation about the independence of the auditors at the banks. The argument has been made, for example, that independence might be compromised by the involvement of auditors in securitisation and other non-audit work. Certainly this is an issue that deserves exploration, and PIRC has carried out some initial analysis of disclosures made by UK-listed banks in respect of auditor fees in relation to securitisation and other non-audit work. This is included as an appendix.

It is unfortunate, though not untypical, that banks' disclosures do not provide a great deal of detail on non-audit work. However, the reports of two banks – Northern Rock and RBS – specifically highlight work on securitisation. In addition it is notable that in the majority of cases UK-listed banks have paid considerable fees to their auditor for non-audit work. We share the view expressed in the committee's report on the failure of Northern Rock published last year that this creates a conflict of interest.<sup>100</sup>

In fact the level of non-audit work carried out for banks by their auditors would often fall foul of our view of best practice in this area. Our more detailed views on the audit process, including the appropriate level of non-audit work, are set out below.

### **Non-audit work**

We disagree with the view that audit firms can be employed to provide consultancy services to the management at the same time as undertaking an independent audit on behalf of the shareholders. We firmly believe that other commercial interests can compromise auditors in their ability to confront directors on difficult issues.

As a general principle, we consider that other professionals should undertake all non-audit work and would wish to see a prohibition on non-audit services being provided. The regulations regarding the disclosure of non-audit work were updated in 2005. These remove the loophole whereby UK companies only need to disclose non-audit fees incurred by the UK incorporated members of the group. Most companies disclose global non-audit fees, and PIRC believes that any company not doing so in 2009 should explain its reasons. In the absence of a good justification, we will normally look to hold a member of the audit committee accountable for the omission.

The new regulations require disclosure under ten headings.

1. Statutory audit
2. Other services supplied pursuant to legislation.
3. Other services relating to taxation.

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<sup>100</sup> <http://www.publications.parliament.uk/pa/cm200708/cmselect/cmtreasy/56/56i.pdf>

4. Services relating to information technology.
5. Internal audit services.
6. Valuation and actuarial services.
7. Services relating to litigation.
8. Services relating to recruitment and remuneration.
9. Services relating to corporate finance transactions.
10. All other services.

Given current practices, PIRC considers that fees paid to the auditor for work covered in headings other than 1 or 2 should be no more than 25% of the audit fee.

Given the broad nature of the headings, specific details of the nature of the work undertaken are required in order for shareholders to make a judgement. Taxation is potentially one of the most controversial areas given the scope for reputation risk. In normal circumstance PIRC does not consider tax advice to be acceptable work.

Although there may be no legal or regulatory requirement for overseas companies listed on the London Stock Exchange to disclose details of fees paid to auditors, PIRC will apply the same standards to such non-UK companies.

#### **Audit partner**

The Companies Act requires the lead audit engagement partner to sign in his /her own name on behalf of the firm. PIRC believes that companies should in their 2008 accounts identify the individual together with his /her date of appointment and the length of tenure of the audit firm.

Where company directors have been senior employees or partners in an audit firm in recent years, there remains the risk of the loss of an outsider's independent perspective, notwithstanding the requirement for a two-year cooling-off period. If

a new director is appointed after the requisite cooling off period, then PIRC will look for the company's audit committee to explain the actions the company and the audit firm have taken to minimise any threats to independence and objectivity.

#### **Auditor rotation**

PIRC continues to see a risk that over time the auditor's familiarity with the audit client's affairs results in excessive trust.

If the same firm continues to hold the position of auditor for many years, then previous judgements are not subject to outside scrutiny. We do not consider that rotation of the audit partner, within the same firm, is sufficient. We maintain that firm rotation after a period of five years is best practice.

We list below the leading UK-listed banks and when they have appointed auditors. Notably most do not disclose the date of appointment, despite our repeated request that they do so.

Bank	Auditor	Date of appointment
Barclays	PricewaterhouseCoopers	Not disclosed

Lloyds TSB	PricewaterhouseCoopers	Not disclosed
HBOS	KPMG	2001
RBS	Deloitte & Touche	2000
HSBC	KPMG	Not disclosed
Standard Chartered	KPMG	Not disclosed
Alliance & Leicester	Deloitte & Touche	Not disclosed

### **Authorising audit fees**

By law, shareholders have to approve the auditors' fees. It is usual for a resolution to be put which seeks authority for the directors to determine the auditors' fees. PIRC accepts that it is appropriate for the directors to do this. It is also common for the authority to determine the fees to be included with the resolution to appoint or re-appoint the auditors. While this is technically a bundled resolution, PIRC does not regard it as a material voting issue so long as there are no concerns over the appointment of auditors or the disclosure of fees for non-audit work.

### **Auditor liability and indemnification**

In our view it is inappropriate for auditors to be indemnified by the company, or for the company to purchase liability insurance for them, as such relationships may affect independent judgement. Any such provisions in company articles should be removed. Under sections 532 to 538 of the Companies Act 2006 auditors will be able to limit their liability by contract provided that shareholder approval is obtained. PIRC is not in favour of such agreements.

### **Internal audit**

We consider that, in almost all cases, internal audit functions are appropriate for listed companies. Boards that have determined such a function is not required should justify their position. A company's auditors should not undertake internal audit functions for that company.

### **Whistleblowing**

The 2003 Combined Code introduced a responsibility on the audit committee to review 'whistleblowing' arrangements. PIRC believes that this is an important element in bolstering public confidence in business legitimacy, ensuring good employee relations, and protecting the company from serious risks. PIRC would welcome meaningful high-level disclosure in the annual report of the company's procedures. In particular it would be beneficial to shareholders if companies disclosed information such as how the whistleblowing mechanism was reviewed, whether the mechanism had been used during the year, how far it is 'independent', what had been the outcome, and if a report is disclosed to all employees, or publicly.

### **Audit Committee Report**

In addition the Code requires that the committee should be provided with sufficient resources, that its activities should be reported in a separate section of the directors' report (within the annual report) and that the chairman of the committee should be present to answer questions at the AGM. PIRC believes that the audit committee's report is a cornerstone of good governance and that its

approval by shareholders should become a regular agenda item at the AGM of companies. When constructing the report, the board should be aware of the guidance provided in the Smith Report. In particular, PIRC believes such a report should cover the issues dealt with by the committee in the year under review rather than merely describing the duties of the committee, or attendance.

## **1.6 Possible reforms to the remuneration structures prevalent in financial services.**

### **Public policy issues**

PIRC believes that the initial guidance formulated by the Financial Services Authority provides a useful framework for financial institutions to use to configure their bonus policy, even if it is rather a restatement of good practice.<sup>101</sup> Clearly there must be a shift towards remuneration policy that rewards long-term value creation, rather than short-term risk-taking. In addition there is emerging new practice that deserves proper consideration. PIRC believes that the bonus-malus system adopted by UBS contains features that could be applied more widely.

Clearly remuneration policy at financial institutions poses challenges to shareholders since often the effects below board level are very important. The nature of company reporting on remuneration further increases the focus on board members with, for example, typically very little or no discussion of pay across the company. Therefore there is a compelling argument that further consideration should be given to the rules covering disclosure of information in companies' remuneration report.

We also believe that a review should be undertaken into the use of shareholder voting rights by institutional investors in respect of remuneration. The UK now has six years' experience of a shareholder advisory vote on remuneration policy. This is enough time to conduct a comprehensive review of both the impact of the vote on executive remuneration (structure, absolute level and in comparison to pay and benefits within the same company) and how shareholders have used the rights in practice. PIRC does not believe that all fund managers have exercised these rights effectively on behalf of their clients (see further discussion under point 4.2).

We list below votes for on remuneration-related resolutions at UK-listed banks in recent years to illustrate the lack of shareholder pressure.

Bank	AGM year	Resolution	Vote for
<b>Alliance &amp; Leicester</b>	2008	'Approve the Remuneration Report'	97.2%
	2006	'Approve Alliance & Leicester 2006 Restricted Share Plan'	98.5%
	2006	'Amend rules of the Share Incentive Plan'	98.7%

<sup>101</sup> [http://www.fsa.gov.uk/pubs/ceo/ceo\\_letter\\_13oct08.pdf](http://www.fsa.gov.uk/pubs/ceo/ceo_letter_13oct08.pdf)

	2006	'Approve the remuneration report'	97.0%
	2006	'Approve Alliance & Leicester 2006 Deferred Bonus Plan'	98.4%
	2006	'Approve Alliance & Leicester 2006 Share Option Scheme'	95.4%
<b>Barclays</b>	2008	'Approve the Remuneration Report'	90.5%
	2007	'Remuneration Report'	94.2%
	2006	'Approve the remuneration report'	94.1%
<b>Bradford &amp; Bingley</b>	2008	'To approve the Directors' Remuneration report'	95.9%
	2008	'To approve the increase to the EIP maximum amount to be applied in the acquisition of deferred shares '	85.4%
	2006	'Approve the remuneration report'	86.6%
<b>HBOS</b>	2008	'Approve the Remuneration Report'	82.9%
	2007	'Remuneration Report'	96.9%
	2006	'Approve the remuneration report'	98.5%
	2006	'Approve the Extended Short Term Incentive Plan'	95.6%
<b>HSBC</b>	2008	'Approve the Remuneration Report'	81.8%
	2008	'Amend the rules of the HSBC Share Plan'	84.2%
	2006	'Approve the remuneration report'	95.2%
<b>Lloyds TSB</b>	2008	'Approve the Remuneration Report'	89.6%
	2006	'Approve the directors' remuneration report'	93.9%
	2006	'Approve the new long-term incentive plan'	95.2%
<b>Northern Rock</b>	2006	'Approve the remuneration report'	89.2%
<b>RBS</b>	2008	'Approve the Remuneration Report'	88.8%
	2006	'Approve the remuneration report'	92.4%
<b>Standard Chartered</b>	2008	'Approve the Remuneration Report'	89.4%
	2006	'Approve the remuneration report'	93.8%
	2006	'Approve amendments to 2001 Performance Share Plan'	94.4%
	2006	'Approve the 2006 Restricted Share Scheme'	96.5%

Finally, we should be clear that standard approaches to remuneration have incentivised inappropriate behaviour. For example, in a special audit demanded by its shareholders, UBS acknowledged that its internal remuneration policy made little adjustment for risk, so staff benefited in the short-term despite the fact that positions made could cause problems at a later stage, and as such did not protect the bank's long-term interests.<sup>102</sup>

<sup>102</sup> <http://www.ubs.com/1/e/investors/releases.html?newsId=140339>

Such serious failings have emerged despite the fact that remuneration policy has presumably been designed to encourage effort in the interests of shareholders. Therefore one might question whether a more fundamental review of how incentive pay affects behaviour is required. As a starting point shareholders could, for example, finance research into the impact of incentive pay on behaviour.

We have included a more detailed outline of PIRC's approach to remuneration, and what we consider to be best practice, below.

### **PIRC's approach to remuneration analysis**

Remuneration is not just an issue of the cost to the company. Remuneration policies and practices:

- Send public signals about the company and its values;
- Are an indicator of the overall integrity, accountability and governance standards applied by the board;
- Are an important lever in whether company strategy is fulfilled;
- Can be positively damaging if the wrong incentives are provided; and
- Badly handled, can contribute to a perception of unethical business undermining wider legitimacy; and
- Should also be integrated into the company's risk procedures.

Remuneration policy is all about recognising the circumstances and values of the individual company and its strategic goals and performance drivers and then designing an approach that will reflect and contribute to these. A good remuneration structure will use stretching but achievable targets that are in line with the objectives of the business and the long-term interests of shareholders.

Justification of policy will become increasingly testing with enhanced narrative reporting including key performance indicators, as recognised by the Companies Act. In particular, in light of the current economic crisis, companies will need to further justify in their 2008 remuneration reports how their current policy is aligned to the long-term interest of shareholders if it remains unchanged.

Media coverage of remuneration controversies often focuses on the size of pay packages in absolute terms or relative to average salaries. The most important issue for investors is whether executive remuneration policy is commensurate with actual performance that is of benefit to investors. In order to achieve this, the policy needs to be well thought out and properly operated.

#### **Recognising excess**

Executive remuneration has the potential to be excessive in terms of:

- Absolute levels;
- The amount required to attract, retain and motivate directors of the necessary quality;
- That justified by business performance;
- Relative to the workforce in general for their contribution to business success; and
- Relative trends within society as a whole.

None of these are objectively measurable, but given current public concern remuneration committees will need to demonstrate sensitivity and be prepared to justify the company's approach. Absolute amounts paid in some companies that appear excessive in a UK context may be justified by companies using international comparisons. However, in our experience, these arguments are sometimes used inappropriately. Also, when using US comparators, companies need to be aware of the growing US domestic concern at executives' judgement in this area.

**The remuneration committee should also be sensitive to pay and employment conditions elsewhere in the group, especially when determining annual salary increases.**

Expanding differentials between the boardroom and the rest of a company's employees have significant implications for employment relations and shareholder returns.

Boilerplate statements simply asserting that the committee 'is sensitive ...' are commonplace and insufficient. Quantitative and qualitative evidence is required to demonstrate that directors' remuneration forms part of a coherent policy framework throughout the organisation consistent with the company's goals and culture, so that all levels are fairly rewarded for their contribution. Indeed, as of 6 April 2008, large and medium-sized companies have been legally required to make a statement "of how pay and employment conditions of employees of the company and of other undertakings within the same group as the company were taken into account when determining directors' remuneration".

**A significant proportion of executive directors' remuneration should be structured so as to link rewards to corporate and individual performance.**

PIRC's approach assumes that a director's salary requires an acceptable level of performance. Incentives should be for demonstrable out-performance. In general, annual and long-term awards with an expected value of more than 200% of salary per year will trigger PIRC's matrix for assessing excessiveness. However, excessiveness may be in part offset by exceptionally challenging performance targets or low base salaries.

**The remuneration committee should judge where to position their company relative to other companies. But they should use such comparisons with caution, in view of the risk of an upward ratchet of remuneration levels with no corresponding improvement in performance.**

Market levels of remuneration are an important element but should not be the sole determining factor. The company's own circumstances and culture, the scope and complexity of the job and the experience of the incumbent will be just some of the other factors to consider.

Often, remuneration consultants are asked to undertake a benchmarking exercise across 'similar' companies to come up with a median (or higher) figure. A better use for consultants is for the remuneration committee to set out the objectives of the company's remuneration policy and then ask them to come up with structural remuneration options to contribute towards it.

## **SPECIFIC ASPECTS OF REMUNERATION POLICY**

### **Base salary**

In deciding on the balance between fixed and variable pay remuneration committees should take into account the benefits of fixed pay, namely, simplicity and transparency. Where salaries are significantly higher or lower than the sector average the reasons should be clearly explained. Base salaries should be clearly highlighted and companies should clearly state, and explain, the level of salary increases implemented during the year.

### **Bonuses**

Bonuses should be designed to encourage and reward executive success, objectively measured rather than viewed as an entitlement.

Potential bonuses should:

- Be offered only as part of a considered package;
- Reward short term performance but this focus should not be to the detriment of longer-term strategy;
- Be subject to pre-determined performance targets that relate to the company's objectives, such as its KPIs
- Be capped at a reasonable level; and
- Not be increased without a requirement for better performance.

Amounts paid should:

- Broadly 'fit' with the view of performance in a particular year described in the company's business review;
- Be justified with details of performance achieved during the year against targets;
- Over time, reflect variations in business performance; and
- Require prior shareholder approval, if the bonus was not subject to predetermined performance criteria

### **Significant shareholding requirement**

Executive directors should retain a meaningful commitment in the company by way of shares. PIRC considers that a holding equal to one year's salary is generally an appropriate level, and that this holding should be built up within a specified time frame, ideally no more than three years.

### **Other practices**

A good remuneration policy may be still be undermined by poor practices. These may be indications of how the policy will be implemented in future.

## **DIVERGENCES FROM AN EXISTING REMUNERATION POLICY**

These may include significant discretionary, non-contractual, or ex-gratia payments; failure to apply mitigation; or agreement of new contract terms.

In PIRC's view, any such changes should be subject to prior shareholder approval. Requiring the board to justify itself to shareholders is a useful discipline. Often, the changes appear to shield management from the risks inherent in variable pay - skewing the risk /reward balance.

Controversy can be caused by the committee acting significantly outside a previously stated policy.

## **RECRUITMENT INCENTIVES**

In the short term, compensating a proposed director for the loss of potential rewards from their previous employer or providing upfront cash or share awards as an enticement to join may appear to be in the interest of the company, if it believes it cannot otherwise attract the executive. However, the practice is not in the company's or investors' long-term interests as it contributes to a general tendency to grant such replacement awards, which in turn devalues the retentive effect of share schemes.

Any such awards, when used, should have challenging performance conditions attached to ensure that the company pays only on the basis of the recruit's delivery rather than apparent potential. Under no circumstances will PIRC support the use of a cash payment as part of the recruitment award.

## **SIGNIFICANT SALARY INCREASES**

Salary increases should be explained as a matter of course, in particular when they reach double-digits. PIRC does not consider it appropriate that significant increases be given to simply align with the market, rather it should only be for additional responsibilities.

## **LARGE ONE OFF SHARE BASED AWARDS**

Share based rewards can produce distorted or unsustainable gains for the individual, unrelated to the company's underlying performance, due to market volatility and other factors. Conversely, in bear markets, participants learn that traditional options are not without risk with potentially de-motivating effects. Best practice is to make smaller awards of options or shares each year, so that rewards are less dependent on market timing. If the company believes that it has a case for making a large award, then this will need to be fully explained and justified. PIRC generally does not look favourably on front-loading of incentive awards.

## **OPTION RE-PRICING AND REPLACEMENT**

This practice undermines any incentive effect of issuing options in the first place and is not acceptable as a matter of principle. The perceived need to re-price only arises if excessively large awards were made in the first place and are followed by a decline in share price.

Replacement of underwater options with new awards at a lower market price can have the same effective result as re-pricing and will be viewed with scepticism.

## **AWARD RE-BASING**

In response to a sudden decline in performance, a company may consider it appropriate to alter the performance conditions of awards that are part way through their performance period. Even if changes are not retrospectively applied, we still consider the re-basing of unvested awards to be inappropriate as it undermines long-term performance targets.

## **TRANSACTION BONUSES**

Bonuses for completion of a merger, acquisition, or other transaction assume that the completion of the deal is in itself a measure of success, whereas the

value will be in its impact on long-term performance. Transaction bonuses are strongly discouraged.

### **BELOW-BOARD REMUNERATION**

Although executive directors are the overall stewards of the company, often important decisions and responsibility is also allocated to senior managers below Board level. Senior managers may have similar incentives to those at executive level, but this is not always the case. Given the importance of aligning employee incentives with those of shareholders, PIRC considers that companies should disclose the remuneration structures of senior managers, in order to enable shareholders to assess their appropriateness.

### **1.8 Possible improvements to the architecture of international financial regulation and maintenance of global financial stability.**

PIRC believes that there is a compelling argument for reforms in the governance of regulatory bodies. In the UK we believe that, given our role in much shareholder voting, corporate governance advisory services such as ours ought to have some representation within the corporate governance policy structure of the Financial Reporting Council.

### **1.14 The impact of short-selling in the banking crisis and its regulation.**

PIRC's principal experience of the impact of short-selling is in relation to stock-lending. A number of our clients loan their stock out to other market participants and earn not insignificant fees from doing so.

We recognise that the facilitation of short-selling through stock-lending creates potential conflicts with investors' long-term interests. For one, it is possible that stock-lending is counter-productive if the stock is shorted and returned at a lower value, or having undermined confidence in the investee company. In addition there may be a conflict with shareholder voting. Although many clients stipulate that stock should be returned for the purposes of voting, there is anecdotal evidence that this leads to them being less attractive to those seeking to arrange a loan. As such there may be a financial disincentive for taking ownership responsibilities seriously. Finally, some have made the point, for example, that by making so much stock available to lend, long-term investors like pension funds have made borrowing it very cheap, and the income they can derive from it is therefore limited.

Clearly views diverge on the legitimacy or otherwise of shorting. Some have argued that it allows valuable negative sentiment to be expressed, which can prevent shares from becoming overvalued. Others make the point that shorting has failed to prevent asset price bubbles, and instead may only exacerbate downward spirals in prices and a loss of confidence in the companies whose shares are being shorted. What is certainly true is the growth of shorting represents increased trading, and with it increased trading costs.

These questions do deserve further discussion. PIRC believes that it would be valuable to undertake detailed research into what impact shorting has on prices, both in terms of volatility and price formation. The increased trading costs resulting from shorting should be taken into account in any such analysis. In tandem it would be helpful to review the costs and benefits attached to stock-lending by long-term investors such as pension funds, and in particular its tax exempt status for pension funds. PIRC believes that, as presently constituted, stock-lending is an activity that should be more properly described as ‘trading’ and therefore should be appropriately taxed.

## **2.5 The role of UKFI and its relationship with the part-nationalised banks.**

PIRC concurs with the view that has been articulated by Sir Philip Hampton and John Kingman that UKFI must act as an “engaged investor”. Given the size of the stakes in the banks that UKFI holds this phrase must be given real meaning. It has been said that UKFI will operate at ‘arm’s length’. A document setting out clearly how this policy will be operated in practice should be produced and made publicly available.

PIRC believes that as an asset manager UKFI must adhere to the best practice that the Government advocates for the market as a whole. In addition to setting out its ‘arm’s length’ policy, UKFI should also have a publicly available corporate governance policy. This should describe, for example, how UKFI will address issues such as remuneration policy and election of board directors. Finally, UKFI should also disclose how it votes its shares and the rationale behind its decisions.

We would also urge that UKFI also considers the role of the asset management businesses that form part of the banks in which it has taken an ownership stake. These investors also have an influence over remuneration at investee businesses, including financial services companies, so the voting records of these asset managers should be reviewed. In addition it should be noted that Scottish Widows Investment Partnership does not disclose its voting record, despite this being industry best practice. As SWIP is a subsidiary of RBS it is hoped that this omission will be remedied. The taxpayer now has an interest in ensuring that asset managers whose parent companies are part-nationalised use their influence as shareholders to push for the high governance standards.

## **4.2 The responsibilities of shareholders in ensuring financial institutions are managed in their own interests.**

PIRC believes that there has been a failure of shareholder engagement in the run-up to the current crisis. For example, it is now widely accepted that remuneration policy at banks may have contributed to excessive risk-taking, and delivered short-term rewards at the expense of long-term success. This ought to have been an area where shareholders used their ownership rights to rein in inappropriate policy. In fact PIRC’s analysis of shareholder voting provided earlier has revealed that no UK-listed bank has ever lost the vote on its remuneration report, or come close to doing so.

Unfortunately, beneficial owners such as pension funds typically delegate responsibility for analysing corporate governance issues and the exercise of shareholder voting to their existing fund managers. But PIRC does not believe that many fund managers have the capacity, and perhaps the desire, to undertake this role effectively. PIRC has a staff of over 30 in place in order to deliver a global corporate governance service based on thorough company research. It is hard to see how fund management houses with a handful of corporate governance staff can play this role effectively.

In fact more detailed analysis of fund manager voting and engagement has revealed that there is a wide spread of activity and competence. PIRC's own analysis of the (limited) disclosures made by fund managers in respect of shareholder voting has, for example, revealed one manager that has not voted against a single resolution at a UK-listed bank in six years. A number of others appear to only rarely oppose management. We also expect the situation to deteriorate further. A number of large financial institutions have already cut back the resource they dedicate to corporate governance analysis. This is despite the clearly increased relevance of corporate governance failure in the financial crisis.

Therefore PIRC believes that if shareholders are to provide proper oversight of the governance of financial institutions then there must be a step-change in behaviour. Large investors such as pension funds should either take more responsibility for corporate governance themselves (our preferred option), or keep a much closer watch on how their fund managers deal with such issues. At present not enough shareholders are playing the ownership effectively.

Given the scale of the financial crisis, an evaluation of the role played by shareholders in the governance of financial institutions is surely warranted. In addition, given the obvious public interest in this area (now that the taxpayer part-owns much of the banking sector) PIRC believes that the case for the mandatory disclosure of shareholder voting records is overwhelming and this should be implemented as soon as is practical.

January 2009

## **Securitisation in the UK Banking Sector**

### **Summary**

From the examination of the reporting of eight banks, two explicitly disclose the fees that were paid to auditors relating to securitisation services, namely RBS and Northern Rock. With the remaining banks these fees could potentially be listed under 'other services relating to corporate finance transactions' or 'other services'. The latter is used by HSBC and Standard Chartered to cover 'reviews of financial models', which could also potentially contain securitisation related fees.

**Alliance & Leicester**

The remuneration of the auditors, Deloitte & Touche LLP, is set out below:

	Group & Company	
	2006 £m	2005 £m
Fees payable to the Company's auditors for the audit of the Company's annual accounts	0.4	0.5
Fees payable to the Company's auditors and their associates for other services to the Group:		
Audit of the Company's subsidiaries pursuant to legislation	0.3	0.3
Tax services	0.7	0.8
Recruitment and remuneration	2.3	0.2
Other services	0.1	0.1
<b>Total</b>	<b>0.4</b>	<b>0.3</b>
<b>Total</b>	<b>3.5</b>	<b>1.4</b>

The above figures exclude VAT. The audit fee for subsidiary companies is included in 'Audit of the Company's subsidiaries pursuant to legislation'.

Tax services include a fee in 2006 for taxation advice regarding the sale of the credit card business.

Fees payable to Deloitte & Touche LLP and their associates for non-audit services to the Company are not required to be disclosed because the consolidated financial statements are required to disclose such fees on a consolidated basis.

## Other services (£0.4m)

### HBOS

#### 6. Auditors' Remuneration

The aggregate remuneration of KPMG Audit Plc and its associates for audit and other services (excluding value added taxes) is analysed below.

	Audit and audit-related services £m	Non-audit services £m	2006 Total £m	Audit and audit-related services £m	Non-audit services £m	2005 Total £m
Statutory audit of the Company and HBOS consolidation	0.3		0.3	0.3		0.3
Fees payable for other services:						
Audit of the Company's subsidiaries and associates	6.5		6.5	5.9		5.9
Audit of the Company's pension schemes	0.1		0.1	0.1		0.1
Other services pursuant to legislation	1.4		1.4	2.4		2.4
Tax services (compliance and advisory)		0.9	0.9		0.9	0.9
Services relating to information technology		0.3	0.3		0.3	0.3
Services relating to corporate finance transactions		0.7	0.7		1.0	1.0
Other services		1.1	1.1		1.5	1.5
<b>Total other services</b>	<b>8.0</b>	<b>3.0</b>	<b>11.0</b>	<b>8.4</b>	<b>3.7</b>	<b>12.1</b>
<b>Total</b>	<b>8.3</b>	<b>3.0</b>	<b>11.3</b>	<b>8.7</b>	<b>3.7</b>	<b>12.4</b>

The analysis of 2005 auditors' remuneration has been restated to reflect the new guidance issued by the Institute of Chartered Accountants in England and Wales on the disclosure of auditors' remuneration.

#### 6. Auditors' Remuneration continued

Other services pursuant to legislation includes work in support of regulatory reporting and listing rules and includes the review of the half yearly results ('audit-related services'). Other services relating to corporate finance transactions includes fees for reviews in relation to capital and debt issues, securitisations and covered bond issues.

## Services relating to corporate finance transactions (£0.7m)

### HSBC

## 8 Auditors' remuneration

Auditors' remuneration in relation to statutory audit amounted to US\$44.7 million (2005: US\$47.0 million; 2004: US\$41.7 million).

The following fees were payable by HSBC to the Group's principal auditor, KPMG Audit Plc and its associates (together 'KPMG'):

	2006 US\$m	2005 US\$m	2004 US\$m
Audit fees for HSBC Holdings' statutory audit:			
– fees relating to current year .....	2.7	2.8	2.3
– fees relating to prior year .....	–	0.2	0.7
	<u>2.7</u>	<u>3.0</u>	<u>3.0</u>
Fees payable to KPMG for other services provided to HSBC:			
– audit of HSBC's subsidiaries, pursuant to legislation .....	40.4	42.5	36.6
– other services pursuant to legislation <sup>1</sup> .....	15.4	29.2	13.4
– tax services .....	2.0	2.6	6.2
– services relating to information technology .....	0.6	–	–
– services related to corporate finance transactions .....	1.6	0.3	1.6
– all other services .....	4.1	5.0	4.7
	<u>64.1</u>	<u>79.6</u>	<u>62.5</u>
Total fees payable .....	<u>66.8</u>	<u>82.6</u>	<u>65.5</u>

### Other services

- 'Services relating to information technology' include advice on IT security and business continuity and performing agreed upon IT testing procedures.
- 'Services related to corporate finance transactions' include fees payable to KPMG for transaction-related work, including US debt issuances.
- 'All other services' include other assurance and advisory services such as translation services, ad-hoc accounting advice and review of financial models.

## Services relating to corporate finance transactions (£1.6m) All other services (£4.1m)

### Lloyds TSB

During the year the auditors earned the following fees:	2006 £m	2005 £m
Fees payable for the audit of the Company's current year annual report	6.0	6.3
Fees payable for other services:		
Audit of the Company's subsidiaries pursuant to legislation	2.3	1.7
Additional fees in respect of the previous year's audit of subsidiaries	0.6	–
Other services supplied pursuant to legislation	4.7	0.8
Total audit fees	13.6	8.8
Other services – audit related fees	1.4	1.6
Total audit and audit related fees	15.0	10.4
Services relating to taxation	0.6	0.6
Other non-audit fees:		
Services relating to corporate finance transactions	1.0	0.3
Other services	0.4	0.5
Total other non-audit fees	1.4	0.8
Total fees payable to the Company's auditors by the Group	17.0	11.8

During the year, the auditors also earned fees payable by entities outside the consolidated Lloyds TSB Group in respect of the following:

**Other non-audit fees:** This category includes due diligence relating to corporate finance, including venture capital, transactions and other assurance and advisory services.

## Services relating to corporate finance transactions (£1.0m)

### Northern Rock

#### Services provided by the Group's auditor and network firms

During the year the Group obtained the following services from the Group's auditor, as detailed below:

	2006 £m	2005 £m
Audit services:		
Fees payable to Company auditor for the audit of parent Company and consolidated accounts	0.5	1.0
Non audit services:		
Fees payable to Company auditor and its associates for other services		
- The audit of Company's subsidiaries pursuant to legislation	0.3	0.4
- Other services pursuant to legislation	0.3	0.3
- Other assurance services	0.7	0.8
	<u>1.8</u>	<u>2.5</u>

Other assurance services comprise services provided in respect of securitisation transactions and the raising of wholesale funding. No other non-audit services were provided.

## Other assurance services (£0.7m)

## RBS

#### 4 Auditors' remuneration

Amounts paid to the auditors for statutory audit and other services were as follows:

	Group	
	2006 £m	2005 £m
Fees payable to the Group's auditors for the audit of the Group's annual accounts	0.8	0.6
Fees payable to the Group's auditors and their associates for other services to the Group:		
- The audit of the company's subsidiaries pursuant to legislation	10.8	9.3
<b>Total audit fees</b>	<b>11.6</b>	<b>9.9</b>
- Other services pursuant to legislation <sup>(1)</sup>	5.9	3.3
- Other services relating to taxation	0.2	0.2
- Services relating to corporate finance transactions, including securitisations, entered into by the Group	2.4	4.9
- All other services <sup>(2)</sup>	2.6	6.0
<b>Total non-audit fees</b>	<b>11.1</b>	<b>14.4</b>
Fees payable to the Group's auditors and their associates in respect of pension schemes:		
- Audit	0.3	0.3
<b>Total</b>	<b>23.0</b>	<b>24.6</b>

Notes:

(1) Includes fees for work relating to Section 404 of the US Sarbanes-Oxley Act.

(2) Includes fees relating to the transition to IFRS in 2005.

## Services relating to corporate finance transactions, including securitisations (£2.4m)

## Standard Chartered

#### Auditor's remuneration

Auditor's remuneration in relation to the Group statutory audit amounts to \$3.3 million (2005: \$3.1 million). The following fees were payable by the Group to their principal auditor, KPMG Audit Plc and its associates (together "KPMG"):

	2006 \$million	2005 \$million
Audit fees for the Group statutory audit:		
Fees relating to the current year	3.3	3.1
Fees payable to KPMG for other services provided to the Group:		
Audit of Standard Chartered PLC subsidiaries, pursuant to legislation	7.6	7.7
Other services pursuant to legislation	1.6	3.1
Tax services	1.0	0.8
Services relating to information technology	0.1	0.1
Services relating to corporate finance transactions	1.4	0.4
All other services	0.2	0.3
<b>Total fees payable</b>	<b>15.2</b>	<b>15.5</b>

- Services related to corporate finance transactions include fees payable to KPMG for transaction related work irrespective of whether the Group is vendor or purchaser, such as acquisition due diligence and long-form reports.
- All other services include other assurance and advisory services such as translation services, ad-hoc accounting advice and review of financial models.

Services relating to corporate finance (£1.4m)

All other services (£0.2m)

#### Bradford & Bingley

##### Remuneration of auditor and associates

Statutory audit of the Company in accordance with legislation	0.5	0.5
Auditing of accounts of associates pursuant to legislation	0.2	0.2
Other services pursuant to such legislation	0.2	0.5
Other services relating to taxation	0.2	0.1
Regulatory services	0.6	0.5

