

Financial Stability and Depositor Protection

I write to convey the comments of the Association of Chartered Certified Accountants (ACCA) on the above paper. ACCA is a professional accountancy body which is recognised by statute in the UK for company audit, insolvency and investment advice purposes. Our 120,000 members around the world work in a variety of sectors, including public practice, business and the financial sector itself. Whether they are advising clients on their financial affairs, managing the finances of their companies or actively involved in the banking industry, our members, as finance professionals, are all either directly or indirectly interested in the issues discussed in the paper and our comments in this letter are prepared on that basis.

In the paragraphs below we set out some general reactions to the issues raised by the paper. Thereafter, we address some of the specific consultation questions.

(i) Complexity issues

Investment products are becoming increasingly complex. This is, in itself, a significant problem for the regulation of the market and causes difficulties for all concerned, from regulators to directors (including those non-executive directors who aspire to exert supervisory control over their executives) and from accountants and IFAs to consumers. Effective regulatory control at any level depends not only on transparency but on comprehensibility.

(ii) Regulatory objectives and practice

The framework of regulation of the financial sector has become unclear in its purpose. We believe there exists uncertainty as to what FSA is trying to achieve, and in particular to what extent it is committed to protecting the interests of the consumer. We believe the current exercise should set out to clarify these matters. At the same time, it should also be established what exactly the regulatory role of the FSA should be in the light of market pressures which drive some banks to adopt particular products and business strategies. And in the same vein, it must be considered to what extent a national

regulator is able to exert influence and control on matters given that financial institutions themselves, and the current problems in the financial market, are actually global.

The problems which led to the temporary nationalisation of Northern Rock should not necessarily be seen as undermining the regulatory standards now being implemented under Basel II. These rules already call upon regulators to take into account the business models of individual institutions in agreeing suitable threshold levels. The rules of Basel II should certainly be kept under review, but at the same time the manner in which compliance with those rules is monitored and dealt with should be looked at.

We suggest that the primary purpose of regulation, in this context, should be depositor protection. A vital secondary purpose should be efficient operation of the banking system such that responsible business practice is encouraged and imprudent risk taking is met with failure rather than a bail out by the tax payer.

Thus, in addition to depositor protection, the thrust of the regulatory response to the current situation should be on encouraging good management including responsible and prudent banking practice.

We would also urge that, in keeping with the Hampton principle of proportionality, regulators in the banking sector be encouraged to adopt a more focused approach whereby they concentrate their regulatory efforts on those institutions which wield disproportionate market influence and whose failure would pose the greatest threat to the financial system.

These comments notwithstanding, it is clear that UK regulators are limited in what they can achieve on their own and should therefore use their influence to bring about an international or global solution.

(iii) Consumer protection

The review should, as a guiding theme, seek to address deficiencies in consumer protection. As the paper notes, the UK's arrangements for paying compensation to depositors are not especially generous by EU standards. In our view, if depositors are satisfied that they would not lose all their money in the event of a bank crisis, there would be no incentive for them to withdraw their funds en masse in the manner of

Northern Rock. This in itself would ensure widespread consumer confidence in the banking system. On a fundamental level we believe that the regulatory system should recognise the relationship of bank and customer as one that is characterised by trust – personal and business customers should have maximum assurance that their funds will be safeguarded by their bank.

As a priority, the procedures for paying compensation to depositors under the FSCS need to be speeded up.

(iv) Consumer literacy

There is a widespread lack of understanding among consumers, especially personal consumers, about the nature of financial products. Options should be explored to increase levels of financial literacy among consumers and to encourage banks to be more transparent and to communicate more effectively about the nature of their products.

(v) Internal control issues

The role of audit committees in the governance of banks needs to be examined. As with committees of non-executive directors in other specialist sectors, it is increasingly an issue as to whether the members of these committees have the skills and experience to be able to understand the risks that are being incurred by their banks and the strategies that are being adopted by executives to mitigate those risks. We consider that this aspect of the regulatory process might be affected by the recent legal changes in the level of skill and care which the law now expects of all company directors.

The role of internal audit should be seen as being integral to the regulatory process and promoted accordingly. But in keeping with the points already made about growing complexity in the financial sector, it will be important to ensure that, as with other key actors in the sector, internal auditors have the skills, knowledge resources and standing they need in order to maximise the effectiveness of their role.

vi) Accounting and reporting issues

Accounting standards already include substantial requirements for the disclosure of information relating to financial products and risk. We agree with the need for full disclosure of financial information. In practice, however, the usefulness of full information is hindered by its complexity and volume: it is evident that there is currently a widespread feeling among stakeholders that there is a serious dislocation between the amount of information banks publish and its transparency and understandability. The International Accounting Standards Board is aware of this and is consulting on how to reduce complexity in reporting on financial instruments.

It should be acknowledged that there are limitations in the ability of historical accounting information to provide useful information to users. Another relevant issue is that many of the valuations underlying banks' accounts are judgmental: particular areas for concern are banks' own valuations (where an asset value cannot be marked to a market) and when expected losses are not reported until an 'event' happens, with the result that a bank may report 'good' results for the previous year yet at the same time analysts are expecting further write-downs in the next quarter.

There is sometimes confusion between the meaning of 'capital' and 'liquidity'. There is also a fundamental flaw with how credit risk models work. These are based on market risk models which use a normal distribution pattern for assessing risk: with credit there is no real market and there is a long tail to the curve compared with the normal distribution.

(vii) Credit Rating Agencies

The activities of Credit Rating Agencies (CRAs) need to be reviewed. One aspect in particular which we think should be borne in mind is that the reliability of credit ratings tends to vary from country to country. There should also be a critical review of the independence of action of CRAs vis-à-vis client companies. We suggest that an enforceable code of practice could be considered for these agencies.

Our responses to specific consultation questions are set out below.

2 Stability and resilience on the financial system

2.1) Do you agree with the actions being taken by the Authorities in the UK to improve stress testing by banks?

2.2) Have the Authorities correctly identified the issues on which international work on stress testing and risk management should focus?

The approach set out by the FSA seems predicated on the assumption that a regulator can make financial institutions manage their risks. The actions set out in 2.35 are sensible but will work only if banks and their staff are rewarded for sound management and pay a penalty for poor risk taking. If senior bankers and traders were to lose financially when things go wrong they would probably already have implemented sound risk management systems. We consider that, unless the weaknesses in the current remuneration environment are addressed, risk management will not be handled with the seriousness it deserves.

There has been an over reliance on models and this is likely to be worse under Basel 2. We understand that stress testing tends to be based on 'business as usual' conditions and excludes more extreme conditions which exist every 10 to 15 years. Models which based stress tests on the sorts of conditions which have existed over a longer time period, say 20 years, would have demonstrated that certain types of business activity were too risky to be contemplated.

We are reminded of the words of Chuck Prince, former Citigroup CEO, 'as long as the music is playing, you've got to get up and dance. We're still dancing.' We suspect that on occasion, models deliberately excluded using conditions which would make a transaction appear unsound. We suggest a complete re-think is now required on banks' attitude to risk and how to regulate their risk management.

2.3) Have the Authorities correctly identified the issues on which the work on liquidity regulation should focus?

The events at Northern Rock and Bear Stearns have highlighted the fact that any bank is vulnerable to a run on its assets. News travels instantaneously and a bank which one minute seemed to have sufficient funds can suddenly find it does not – irrespective of the truth of such news. We have reservations about the likely effectiveness of the approach outlined in the paper: long-standing approaches to liquidity regulation no longer seem fit for purpose in the present environment where size, volume, complexity and interconnectivity of banking operations have mushroomed. Fresh thinking is required.

2.4) Do you agree with the actions being taken by the Authorities to encourage full and consistent valuation and disclosure by banks?

Consistent valuation and disclosure is not a complete solution. We note that one major UK bank recently reported £1,500 million fair value gains on its own debt owing to changes in credit spread. We understand that this gain was caused by diminution of the market value of debt that bank had issued. A bank with a poorer credit rating would presumably have suffered a bigger diminution in value of its debt so could have reported a higher gain. ACCA has significant misgivings about the recognition in financial statements of the value of changes in own credit risk and has opposed its incorporation in accounting standards.

There is also, as noted above, a problem with the complexity and the volume of disclosure. The annual reports of the UK's larger banks now run to several hundred pages each and are not readily comprehensible even to specialists. The nature and significance of material figures, such as the fair value gains referred to in the preceding paragraph, are not easy to discern.

2.5) Have the Authorities correctly identified the issues on which international work on accounting and valuation of structured products should focus?

We agree with the issues identified in the paper concerning the accounting and valuation of structured products. In addition, we think the standard setters and others should look at the valuation and associated disclosures when previously active markets cease to

function properly and may therefore no longer provide reliable values for some financial instruments.

2.6) Have the authorities correctly identified the issues on which international work on credit rating agencies should focus?

2.7) Do you agree with the Authorities' proposals to improve the information content of credit ratings?

2.8) Do you agree with the Authorities that the preferred approach to restoring confidence in ratings of structured products is through market action and, where appropriate, changes to the IOSCO Code of Conduct on Credit Rating Agencies?

The problems with credit rating agencies which the consultation has identified have been around since at least the early 1990s. Dealing with these issues is long overdue but now much more important because Basel 2 relies so much on models and on credit rating agencies doing a good job. We support the actions proposed.

2.9) Have the Authorities correctly identified the issues on which international work on banks' exposures to off-balance sheet vehicles should focus?

We agree that the paper has identified the key issues relating to off balance sheet vehicles.

3 Reducing the likelihood of a bank failing

3.3) To what extent are the annual and one-off costs of the new information requirement on banks proportionate? Can they be quantified?

3.4) How effective would the new information requirement be in identifying and addressing a sudden deterioration in a bank's financial soundness?

We consider that the steps set out in 3.14 to 3.22 are impractical. We do not think it is possible for a regulator to form a reliable opinion about whether a bank will remain a going concern. As set out above, a way needs to be found of making sure banks are run more

prudently and do not take the type of risks which have characterised markets recently.

3.5) Are there circumstances in which it would not be appropriate for the FSA to collect and share the information that the Bank of England or HM Treasury require?

It is for the three regulatory bodies to decide what information to share.

3.8) To what extent is the current provision to register charges at Companies

House relevant to banks? Do you agree that it is appropriate to amend it?

3.9) Should any exemption for banks only apply to receipt of Emergency Liquidity Allowance (ELA), or should there be a more general exemption for all types of lending?

3.10) Would extending the 21-day period be a viable, alternative proposition?

Disclosure and transparency are vital principles and there needs to be a very good reason not to uphold them. Reducing the information available could provide short term protection to banks which have taken imprudent risks and deserve to suffer. This would not be in the public interest although there is an obvious benefit for the banks concerned. Banks should be aware of the risks of running out of money and know that the cost of doing so will be their failure not a cost to the tax payer of saving them. Such knowledge would encourage responsible banking.

We recognise however that there is a global aspect to this and global action is needed. It would also be wrong for UK banks to suffer compared with banks from other countries which may have less strict requirements for disclosure.

3.11) What would be the effect of removing the 'weekly return' reporting

requirement? What other statutory reporting requirements disclose ELA?

As indicated above, it is necessary to deal with the heart of the problem which is irresponsible banking. ELA does not, in our view, encourage responsible banking and if provided should be done transparently.

3.14) Do you agree that funds provided by the Bank of England should be exempted from calculation of building societies' wholesale funding?

Yes

4 Reducing the impact of a failing bank

Q 4.1 Do you agree that there should be a special resolution regime for banks?

We accept that such a regime may be necessary as a last resort. We therefore agree that regulatory mechanisms should be available which provide the authorities with the powers necessary for them to intervene quickly and decisively in the affairs of individual institutions so as to protect the interests of investors and creditors and to maintain confidence in the financial markets generally.

Q 4.4 Do you agree with the special resolution regime process as outlined?

The Special Resolution Regime (SRR) as proposed does not appear to amount to one single line of regulatory response but rather a regime of last resort in which the authorities take actual control of a bank and assume powers to control and direct the affairs of the bank concerned. Given the potential risks to the authorities of such direct intervention, it is right that the SRR should only be contemplated after all other regulatory avenues have been tried and have failed to resolve the problems. Since, however, only one of the regulatory tools that are put forward is to put the bank into a special 'insolvency' procedure', it would appear that the SRR is being seen not solely as a means to wind up a failing bank but also as a procedure for putting a

bank into a form of high level intensive care. If the intention is in fact to allow for the possibility that a bank under SRR could recover and continue operating in some reduced form, it will be essential to provide in the planned legislation for the SRR to expire and for the responsibilities of the authorities to do likewise, and if necessary for the powers of the bank's directors to re-apply.

It seems clear, given the stress that the document places on the need for the SRR to be used to prevent damage to wider financial stability, that the regime would be resorted to for public policy purposes. In the interests of certainty for all stakeholders, however, we suggest that the authorities should develop a coherent overriding rationale for what the SRR would aim to achieve, as opposed to just the criteria which would trigger the regime and the tools which would be available while it was in force.

Q 4.14 Should a new bank insolvency procedure be introduced for banks and building societies?

The new procedure as envisaged in the document appears to be essentially a liquidation procedure but with the possibility of allowing the bank concerned to enter into a CVA and thereby continue in existence.

Whether or not there is a need for a new, dedicated insolvency procedure for banks would depend mainly on whether the intention is to provide for substantially different rules regarding priority of claims, including the claims of secured creditors. As it stands, the document suggests only that there would be enhanced emphasis, in the new procedure, on making early payouts to depositors under the FSCS. If speeding up the process of making payouts to depositors is to be the main goal of the new procedure, the feasibility of this would appear to be disputed by the statement in para 4.36 which says that the FSCS is not set up to process large volumes of claims in a short time. Clearly, expediting compensation payouts is an issue which needs to be addressed irrespective of the introduction of a new insolvency procedure.

The exact nature of the proposed procedure should be made clearer in due course. But we would query whether, given that the insolvency option would be the last resort of the SRR (which would itself be a

regulatory mechanism of last resort) there needs to be provision made for entry into a CVA. Also, we see no reason why, at this stage, the matter could not be taken over by a licensed insolvency practitioner. The SRR, and the appointment of the restructuring officer, could continue but in a more supervisory vein, with the insolvency practitioner reporting to the officer and the authorities.

Lastly, we suggest that the restructuring officer should have power to petition the court for an order to put the bank into the new procedure.

Q4.22 What should the governance arrangements of the SRR be?

We suggest that, in the light of the very strict and wide-ranging criteria which the document envisages would be assessed before resort to the SRR was contemplated, all three authorities should be jointly involved in that decision and should be jointly involved in overseeing its application, via a joint supervisory committee formed of a representative from each. It would be appropriate for there to be provision for a 'restructuring officer' or some such and for that person to be given operational responsibility for applying the tools which the authorities have jointly decided to use. But the officer should act as the agent of the joint authorities and be accountable to them.

Q4.23 Do you consider that introducing the office of the restructuring officer would be a helpful and necessary development?

Yes, but the role of the officer and the powers available to him will need to be set out expressly.

Provision will need to be made in legislation for the restructuring officer to assume control over the bank's affairs. Provision will also need to be made for the powers of the directors either to cease or, more likely, to be made subordinate to the restructuring officer, as is the case in liquidations. If the SRR is to allow for the possibility that a bank may survive, then it would of course make sense for the directors to stay in office, at least nominally. The restructuring officer, and also the appointing authorities themselves, would certainly meet the current statutory tests of director and shadow director. There would

therefore have to be express provision in legislation to the effect that those persons are not to be deemed to be directors and shadow directors.

Q4.24 Additional comments on implications for shareholders and creditors

We query the statement made in para 4.53, where the document says that statutory protections for creditors, including the rules on wrongful trading and fraudulent trading, would be suspended once the restructuring officer was appointed. These provisions, which apply only once a company has actually entered into insolvent liquidation, make individual directors liable in respect of reckless trading decisions made in circumstances where directors knew or should have known that corporate was inevitable. We agree that directors whose powers have been suspended by force of law should not be held liable for their actions or inactions during the period concerned. But should the bank subsequently go into liquidation we see no reason why directors should not continue to be held responsible for their conduct in the period leading up to the application of the SRR. If there is to be a new, dedicated insolvency procedure for banks, then the decision will have to be made as to whether the wrongful and fraudulent trading rules should apply to that new procedure: we consider that they should.

5 Consumer Confidence and Compensation Arrangements

Q 5.1 How would a higher compensation limit effect consumer confidence?

The success of the financial services retail market is dependent upon consumer confidence in the products and services in that market. The confidence factor is significantly more important in the financial services markets as compared to other retail markets because of the complexity of the products and their intangibility.

An important element of consumer confidence is that consumers should feel they benefit from a 'reasonable' level of protection in this market. In terms of consumers depositing money in banks there is arguably a widely-held expectation among consumers that such

transactions are risk-free. A similar argument was articulated in the response of FINUSE (the EU's consumer forum on financial services) to Solvency II, in the case of insurance/assurance products. The apparently poor awareness of compensation levels on the part of consumers is perhaps not surprising when one considers that consumers seem to have high expectations of being able to recover their money, if necessary, in the form of compensation.

We believe that the adoption of a higher deposit compensation limit in the UK would in itself enhance consumer confidence in the banking system. It should also be recognised that co-insurance levels and compensation limits were not the only motives for depositors withdrawing their money from Northern Rock. The fact that the company's management was seen to have 'failed' is a reasonable motive for consumers to withdraw deposits.

Q 5.2 How would a higher compensation limit affect the responsibility consumers have for their financial choices?

As stated, we believe that options needs to be explored to enhance the level of financial literacy among the UK population. ACCA as a body is committed to doing just this. But there can sometimes be too much attention given to the idea that consumer financial literacy is the solution to the problems they experience in the financial services retail market. The products available to consumers are often extremely complex, and increasingly so, and it is difficult for the great majority of consumers to assess contracts in terms of their risks and protection. In our view, the role of intermediaries should be addressed in the context of efforts to encourage consumers to think more carefully about their investment decisions. In this light, high risk products that consumers may choose to invest in should not be subject to any compensation subject to the sellers being able to demonstrate that they reasonably conveyed this risk to their clients

I hope these comments will be of help. We would of course be happy to discuss any of the contents of this letter with you in greater depth should you wish to do so. You may also be interested to know that on 23 April ACCA held a public meeting to discuss not only this review but current market issues generally. The event was attended by around 400 senior individuals from the financial services sector and a



very lively discussion ensued. The discussion was recorded and the resulting tape will be published soon on the web sites of both ACCA and the Securities & Investment Institute.

Yours faithfully