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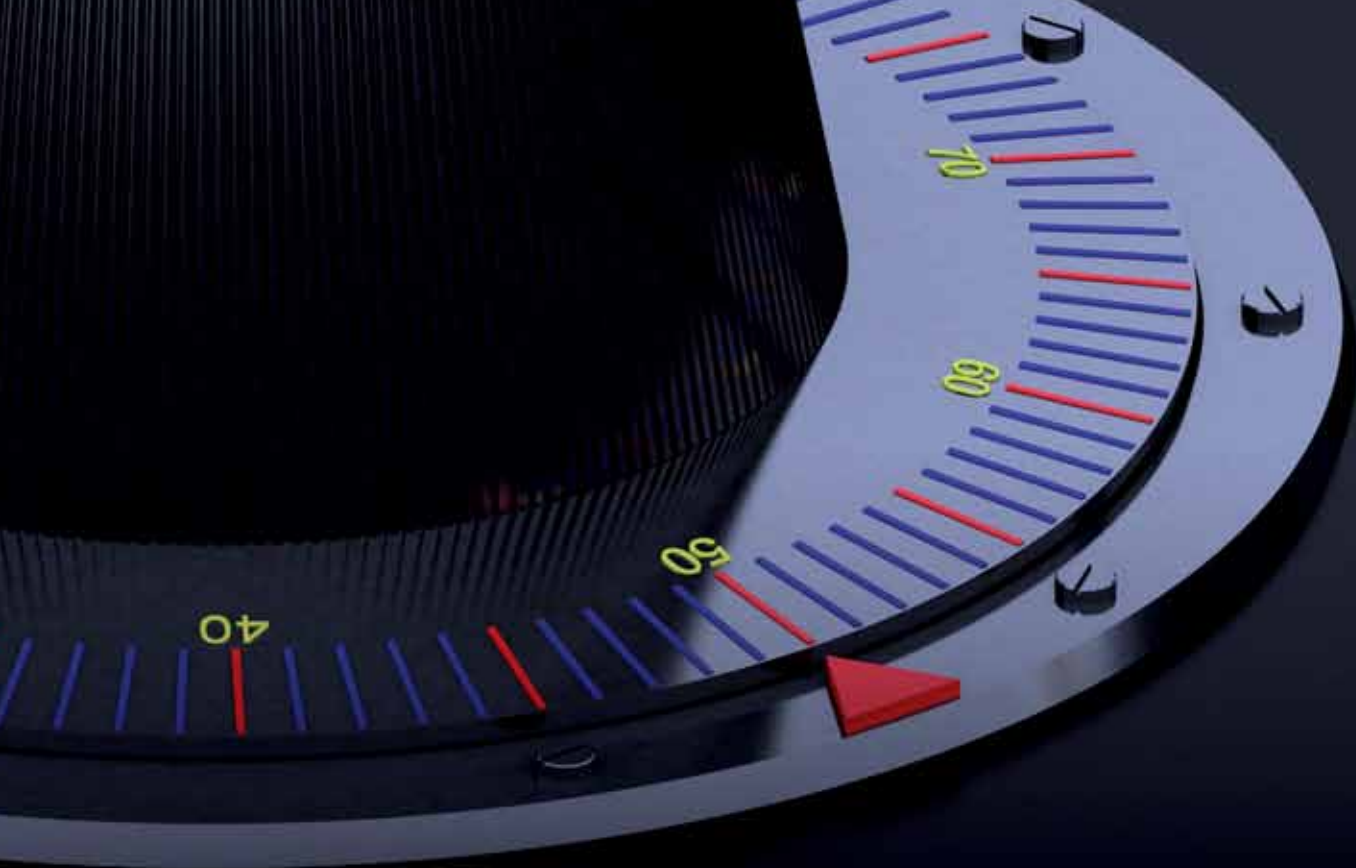
MEMBERS' MAGAZINE

Risks mount for central banks

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revolution

18 Is UK distribution reform
the right model?

22 Managing the
regulatory burden



THE CHANGING LANDSCAPE

FINANCIAL AND REGULATORY REPORTING FOR INSURERS

9 November 2011, 08:30 – 17:00, London

This conference will help you understand and implement changing reporting requirements for insurers. Focusing on Solvency II and the forthcoming insurance International Financial Reporting Standard, the comprehensive programme includes a round-up of developments in the areas of section 166 reports, client assets and tracing employers' liability insurance.

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BUSINESS WITH CONFIDENCE



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Faculty update

RETAIL REGULATION: PAST, PRESENT AND FUTURE

On 19 July the faculty hosted this successful event, with leading experts addressing a wide audience of financial services and investment professionals. Simon Godsave (UK Life Compliance Director, Zurich Financial Services) outlined the rationale behind the UK regulatory model and summarised how this had been applied over the past 25 years. Andrew Power (Insurance Partner, Deloitte) provided details of the UK and international regulatory landscape moving forward, stressing the importance of European and international regulatory initiatives.

Richard Bertin (Managing Partner, Asquith & Partners LLP) chaired the event, facilitating a lively discussion during which attendees reflected on their experiences of regulation in the retail financial advice and investments sector, achievements and failures, and explored ideas for how to deliver better regulation. The event highlighted the sheer breadth and volume of regulatory change that the sector will have to digest over the course of the next few years. Attendees were not convinced that changing the regulatory framework would necessarily resolve the longstanding issues facing the sector, and that improved consumer outcomes would require higher standards of operational supervision moving forwards.

TREASURY COMMITTEE BELIEVES THE RETAIL DISTRIBUTION REVIEW (RDR) SHOULD BE DELAYED FOR 12 MONTHS

The Treasury Committee report, published on 16 July, argued that the implementation of the RDR should be delayed for 12 months to give more time to advisers to meet the new qualifications standards. The committee supported the banning of commission but called for a review of the long-stop, and stated that more work is still required to develop simplified advice. The report also highlighted the need for clearer guidance on VAT and that more work is required to raise the awareness of the general public on what the RDR will mean for consumers. The report can be accessed at publications.parliament.uk/pa/cm201012/cmselect/cmtreasy/857/857.pdf

ISLE OF MAN REGULATOR AND THE RDR

The Isle of Man's regulator has announced it does not intend to allow grandfathering as part of its own RDR implementation.

The Financial Services Commission has written to practitioners on the Island confirming it expects advisers to hold QCF level four qualifications from 1 January 2014, and does not intend to allow grandfathering.

ICAEW RESPONDS TO THE INDEPENDENT COMMISSION ON BANKING (ICB)

ICAEW has submitted a response to the interim report published by the ICB in April. We focused mainly on the possible ring-fencing of UK retail banking. ICAEW argued that while this could make a contribution to ensuring continued credit supply in stressed market conditions, and to reducing the likelihood of taxpayer support to banks in future, it is nonetheless not a panacea.

There would be significant risks within ring-fenced UK retail banks, such as exposure to mortgage loans. Moreover, important risks would lie in entities outside the ring fence. It remains possible that financial distress in the latter could require taxpayer involvement – especially regarding banks which operate on a cross-border basis, where not all mechanisms needed to facilitate resolution without public funds are in place.

We noted that crucial questions remained regarding what types of business would be required, or permitted, to be inside the ring fence. This would have a major effect on the viability of the business model and balance sheets of UK retail banks, not least by affecting the feasible level of profitability.

UK REGULATORY REFORM

On 16 June, the Government published a white paper on the proposed new structure of financial regulation, which included a draft of the Bill to amend the Financial Services and Markets Act 2000 in order to put the changes in place. The faculty is looking closely at the possible impact of the proposals on both the accountancy profession and the financial services industry. ICAEW will be responding to the white paper; comments are due by 8 September.

From the faculty

Beware: August angst



Whatever happened to the lazy days of summer? The holiday period has again been tumultuous. It has become a feature of this financial crisis. Markets have been spooked by events in the Euro-zone and the need for another Greek bailout. There is increasing concern that the problems will spread further, not just to Portugal and Ireland, but also Spain and Italy. Meanwhile, the US was pushed to the brink of running out of money by its cap on national debt and deadlock in Capital Hill over raising this.

Credit rating agencies have been criticised in Europe for downgrading various countries, not just Euro-zone countries to near default levels, but also taking away the AAA rating of the US for the first time; there are also rumours that the French AAA rating may be under threat. The criticism of the ratings agencies seems irrational – what else are they supposed to do, given global economic conditions? The downgrades did not tell markets or the world anything that it did not know about the weak state of many economies.

The timing of the problems created difficulties for banks in their interim reporting. Decisions had to be made over whether to write down exposures, which ones, by how much and what to disclose. Several urgent conference calls and meetings were held in late June and early July, amongst audit firms, regulators and, no doubt, banking associations.

Some banking regulators put significant pressure on banks over how to account for exposures to certain countries, particularly Greece. This has not traditionally been seen as an area for which banking supervisors have any authority, at least in the UK. A far bigger problem, however, was that the regulators took sometimes diametrically opposed positions.

Given the potential for different treatments, ICAEW issued a statement calling for clear disclosures of sovereign debt and other exposures on a country-by-country basis. Analysts have been pouring over banks' and insurers' disclosures in the half-year results. Comparisons across Europe have indeed shown inconsistency. Some banks wrote down Greek debt exposures to fair value, taking as much as a 50% hit; others wrote them down by 21%, the figure for the private sector haircut in a proposed package from the Institute of International Finance (IIF). Some banks argued that no write down was needed as this IIF package happened after the half-year (and presumably that all was fine at that time).

While clear disclosures allow analysts to see through this and make adjustments, the fact that they need to do so does not increase confidence in financial reporting.



Iain Coke
Head of the Financial Services Faculty

EVENTS PROGRAMME FOR 2011

The Financial Services Faculty would like to invite you to its programme of autumn events.

REPORTING BY FINANCIAL SERVICES FIRMS: A ROUND-UP OF IASB CHANGES

Thursday 15 September, 09:00–10:30

How will the IASB's work impact financial services firms? To answer this question, this seminar will provide an overview of recent and forthcoming changes, including in the areas of leases, consolidation, financial instruments and impairment.

BASEL III WORKSHOP: IMPLEMENTATION GETS UNDERWAY

Wednesday 28 September, 09:00–17:00

Basel III – the new regulatory framework for the banking industry – is now agreed. It represents a landmark agreement on both capital and liquidity requirements. This workshop will explore the challenges and issues which are emerging as work proceeds to implement the new approach.

FINANCIAL AND REGULATORY REPORTING FOR INSURERS

Wednesday 9 November, 09:00–17:00

This one-day conference will help you understand and implement changing reporting requirements for insurers. The comprehensive programme focuses on Solvency II and the IASB's work, and addresses developments in section 166 reports, client assets and tracing employers' liability insurance.

AN INTRODUCTION TO THE APB'S NEW CLIENT ASSETS BULLETIN

Thursday 17 November, 09:00–10:15


The Auditing Practices Board (APB) will soon be issuing a Bulletin on client assets reporting, and this is your opportunity to find out what is expected from auditors under the new Bulletin. The session will also outline the FSA's proposals for a client money and custody assets resolution pack (CASS RP).

Further details of all the above events can be found at icaew.com/fsf

Cover story

Risks mount for central banks





The Bank of England – the ‘banker’s bank’ in the UK – is undergoing radical change. The recently published Financial Services Bill alters the framework of UK financial regulation in the UK, reversing the innovations of previous Labour administrations. The central measure is the change in responsibilities for prudential regulation. This involves the creation of the Prudential Regulation Authority (PRA) – which will be under the control of the Bank of England (the Bank), out of the part of the Financial Services Authority (FSA) that supervises and regulates the safety and soundness of financial institutions.

Accompanying this transfer of regulatory responsibility is the creation of a new policy committee at the Bank, the Financial Policy Committee (FPC), working in parallel with the Monetary Policy Committee (MPC). This puts the Bank’s responsibility for financial stability on an equal footing with its responsibility for monetary stability. Like the MPC this new committee will be chaired by the governor of the Bank and made up of both Bank officials and independent but non-political members appointed by the Chancellor of the Exchequer.

As a result, the Bank will have greater responsibilities than any other major central bank worldwide. It will have to conduct all the additional research and analysis needed to inform the decisions of the FPC, implement these decisions once they are taken and explain and justify its work to Parliament and through the media to the public at large. It will also have to regulate and supervise hundreds of financial institutions, including insurance companies, commercial and investment banks and the remaining UK building societies. Finally, it will have to be prepared, in the event of another financial crisis, to play the lead role in dealing with the resolution of troubled institutions and stressed financial markets.

‘...[the Bank] will have to be prepared, in the event of another financial crisis, to play the lead role in dealing with the resolution of troubled institutions and stressed financial markets.’

Other central banks are similarly acquiring new responsibilities, such as pursuing financial stability alongside their traditional task of monetary stability. The European Central Bank (ECB) is right in the firing line, dealing directly with the sovereign debt and banking problems of the euro-area periphery. The Dodd-Frank Act in the US gives the Federal Reserve new responsibilities for supervising systemically important investment institutions and financial infrastructures, as well as playing a leading role in the cross-agency US Financial Stability Oversight Council.

Other central banks around the world are also acquiring a macroprudential remit, with responsibility for containing systemic financial risks as well as inflation. In many cases they also have to deal with the aftermath of the global financial crisis. This might involve a legacy of troubled banks with high levels of non-performing assets, or the opposite problem of soaring asset prices and excessive credit growth in other countries, regarded as safe by international investors and attracting short-term capital inflows.

THE PENDULUM HAS SWUNG BACK

These are major changes that mark the end of two decades of narrowing of central bank responsibilities. Since the early 1990s, the Bank has been at the forefront of a worldwide trend towards increased central bank responsibilities and greater independence from direct political control. This dates from ‘Black Wednesday’ in 1992, when the UK authorities failed to



keep sterling inside the European Exchange Rate Mechanism.

A centre piece was the adoption (following the earlier lead set by New Zealand) of a formal inflation targeting regime. This had two essential elements. First, the recognition that there is no need for 'intermediate' monetary targets, such as the money supply or the exchange rate favoured by former Prime Minister Margaret Thatcher and her various Chancellors of the Exchequer.

'These are major changes that mark the end of two decades of narrowing of central bank responsibilities.'

'Noise' from these notoriously unstable indicators leads to considerable problems. As the old joke goes, Thatcherite monetary policy had one target – the money supply – and one instrument – the economy. It is more effective instead to adopt a target for inflation itself

and to use monetary policy instruments (of which the key one is the short-term interest rate) in order to shift inflation back towards its target level.

The second, related, element was establishing credibility for this inflation target by putting the conduct of monetary policy at one remove from day-to-day political influence. This is the function of the MPC. The inflation target is set by the Chancellor of the Exchequer (currently at 2%), but the MPC decides how to achieve the target. For a decade, from 1997 to 2007, the MPC was successful at maintaining inflation at around the 2% level. Finally, after 25 years of monetary instability, the UK seemed to have finally tamed the dragon of inflation.

POST-CRISIS UNCERTAINTY

The global financial crisis of 2007 to 2009 revealed the downside of this narrow policy focus. The Bank, together with the other UK financial authorities HM Treasury and the FSA, failed to ensure financial stability. They issued warnings about systemic financial risks, but took no effective action to limit their impact when they materialised. When crisis finally came they were poorly prepared. They struggled to cope first with the failure

of Northern Rock and other smaller mortgage banks, and then with the subsequent loss of confidence in several major banks after the collapse of Lehman Brothers.

These failures were not those of the Bank, or even of the UK authorities, alone. Financial sector problems in the US, measured for example by the scale of bank failure, have been even more severe than in the UK. A number of smaller countries, such as Ireland, Iceland and Latvia, suffered much greater financial crises and economic contractions. Within the euro area, the ending of easy credit has revealed deep-seated problems, such as a lack of competitiveness, unsustainable current accounts and public sector deficits.

‘With their new broad and loosely defined mandates, central banks could well attract blame for further problems in the financial sector, or simply for disappointing growth in output and employment.’

At the same time, financial sector problems have undermined faith in inflation targeting. A weak exchange rate and high commodity and energy prices have created considerable inflationary pressures. But labour markets remain weak (suggesting inflationary pressures should subside) and the Bank is naturally reluctant to respond by raising interest rates, lest this creates renewed financial problems and a sharp decline in output as well as in inflation.

The Bank, like the Federal Reserve, has instead been experimenting with ‘unorthodox’ monetary policy, such as acquiring government bonds and other long-term instruments, a process known as quantitative easing. This, in turn, has put downward pressure on the exchange rate and long-term interest rates, while at a global level it is increasing global asset prices and demand. But the economic impact of these measures remains poorly understood.

RISKS FOR CENTRAL BANKS

This combination of dramatic institutional changes and an uncertain economic environment pose great risks for central banks. The most obvious is that the increased burden of responsibility could overwhelm their decision-making processes. This is a particular concern for the Bank, where the governor and senior officials are likely to struggle with the burden of responsibility for monetary and financial stability and the associated management of the MPC and the FPC.

Financial risks are also a concern. There is mounting disquiet about the high levels of exposure of the ECB

to the sovereign and private debt of the euro area periphery. A sovereign default could have to be followed by a recapitalisation of the ECB itself. This exposure is not necessarily a bad thing – the ECB’s support for the periphery is crucial to minimising the impact of financial instability – but substantial losses would undermine much of the political legitimacy of the ECB.

Central banks in countries with appreciating exchange rates are also exposed to financial risk if they attempt to influence exchange rates by acquiring substantial foreign currency reserves. As the Swiss National Bank has found, such intervention can result in ‘mark to market’ losses, which again undermine the political legitimacy of central bank actions.

A related concern is the lack of clarity about governance. The governance of the Bank is in the hands of the ‘Court’, a large body consisting of nine non-executives together with the governor and deputy governors. This rather unwieldy arrangement did not matter so much for the MPC, which has a clear measurable objective (controlling inflation) and a limited range of operational tools. But governance will be more critical for the FPC as it will not be easy to measure or monitor its success at meeting its objectives, while its choice of policy tools to meet its objectives will, inevitably, be controversial.

How can accusations of arbitrary interference in the economy be avoided? All central banks acquiring new macroprudential responsibilities face a similar challenge. How is the necessary political oversight to be provided without interfering in the pursuit of financial stability?

The potential undermining of hard-won political independence is the biggest risk of all to central banks. The economic environment in the next decade, in the aftermath of massive and unsustainable global credit expansion, will be unavoidably difficult (growth of even 1% per year in the developed world will be a solid achievement).

With their new broad and loosely defined mandates, central banks could well attract blame for further problems in the financial sector, or simply for disappointing growth in output and employment. This, in turn, would lead to great political pressures: for example, to chase short-term output and employment growth at the expense of rising inflation, and to use the range of ‘financial stability’ tools to favour particular interest groups.

The root problem is that financial stability, unlike monetary stability, cannot be a purely technocratic responsibility. Political tensions are likely to surface and, when they do, we can expect to see yet more reworking of the architecture of central banking down the road.

Alistair Milne

Professor of Financial Economics, Loughborough University

The retail regulation revolution



Changes in the UK regulatory landscape took a significant step forward in May and June this year when the Bank of England (the Bank) and the Financial Services Authority (FSA) published documents outlining the approach to be taken by the new Financial Conduct Authority (FCA) and Prudential Regulation Authority (PRA).

These put some detail around the Government's consultation papers and white paper, *A new approach to financial regulation: the blueprint for reform*, published in June. The next step in the legislative process is the start of pre-legislative scrutiny, where

a cross-party committee will analyse the draft legislation. This takes the form of multiple amendments to the existing Financial Services and Markets Act (FSMA) 2000.

As an interim step, towards the middle of 2012 the FSA intends to introduce an 'internal twin peaks' model, trialling the approaches of the FCA and PRA within the FSA and within the limits of FSMA. The new model will engender substantial changes, including the separation of prudential and conduct supervision for dual FCA/PRA regulated firms, and the introduction of new risk analysis approaches and tools.

The imminent changes to the supervisory regime present an urgent need for the industry to seriously consider the likely effects on their businesses and the nature of their interactions with the supervisory authorities. In the Government's white paper, George Osborne, Chancellor of the Exchequer, noted how the new approach 'places the judgement of expert supervisors at the heart of regulation' and that it is a 'programme for radical reform'.

THE FCA: SIGNIFICANT NEW POWERS

In what may prove to be a wake-up call to parts of the financial services industry, the FCA will be equipped with a variety of powers to support its statutory duty to protect consumers from detriment. Among these are the ability to ban the sale of particular products from a given financial institution for up to 12 months, to take action over misleading adverts or promotions and to disclose consequent disciplinary actions against individuals or firms. It will also be able to initiate referrals to the Office of Fair Trading.

'...the FCA will be equipped with a variety of powers.'

Only time will tell how eager it will be to use its new muscles, though it seems clear that the FCA may intervene in an even more intrusive manner than the FSA has

started to recently. Speaking to the British Bankers Association on 2 March, Mark Hoban, Financial Secretary of the Treasury, noted: 'We want the FCA to play a far stronger role promoting competition... [It] will be more interventionist than the regulatory authorities of the past.'

'The primary focus of the PRA will be on financial stability issues and the resolvability of firms that pose a threat to the financial system at large.'

GREATER MARKET-WIDE REVIEW AND POLICY INTERVENTION

One of the FCA's priorities will be to provide higher-level, holistic views of the market and of the business models of individual firms as it seeks to identify potential risk areas for consumers. This is likely to signal a clear and unequivocal move towards sector and thematic supervision and away from relationship supervision.

This shift will bring with it greater market-wide policy interventions along the lines of the Retail Distribution Review and the Mortgage Market Review, together with increased use of the consumer redress process under s404 of the FSMA.

While there may be little discernable difference in current supervision of the markets through the UK Listing Authority (UKLA), wholesale supervision will be stepped up. However it may take some time to ramp up to the FCA's desired level, due to resource constraints.

THE PRA: THE MICRO-PRUDENTIAL SUPERVISORS

The primary focus of the PRA will be on financial stability issues and the resolvability of firms that pose a threat to the financial system at large. Using highly qualified supervisors to judge firms' safety and soundness, it has been given the task of making forward-looking assessments to avert potential difficulties on the horizon and to minimise the risks of disorderly failure. Its starting position of

business model analysis and a new risk model is a fundamental shift in approach in prudential supervision.

Acting under the instructions of the Bank's Financial Policy Committee to tackle issues of micro-prudential concern, it is intended that the PRA will bring about a proactive intervention regime to deal with firms that get into difficulties. Paul Tucker, Deputy Governor for Financial Stability at the Bank, described this approach as representing 'a profound review of the social contract between banks and society'.

A MOVE TOWARDS BANKING-STYLE REGULATION?

Providing a swifter and more direct form of action under the proactive intervention framework, firms may feel that the PRA will adopt a much more instructional style of supervision.

Firms should expect a greater emphasis on reporting assurance, published returns and the use of skilled persons' reports, or s166 reviews. The industry may also need to accommodate more intrusive supervision of the UK branches of overseas banks. This may create challenges between the UK and other European regulators, which have traditionally adopted a legalistic interpretation of the roles and responsibilities of 'home' and 'host' supervisors.

It seems likely that insurers will increasingly be regulated more like banks, given the culture, experience and style of the Bank. However, the industry has been at pains to point out that insurers are not banks and, arguably, came through the financial crisis of 2008–09 in a much stronger position overall.

TWO REGULATORS: TWICE THE BURDEN ON FIRMS?

A key concern is how the two new bodies might be able to work in concert. There are already multiple touchpoints between the FSA and regulated firms and there is some concern that the formation of the PRA and FCA will make the coordination and management of

the interactions between firms and regulators even more complex, burdensome and expensive.

The PRA and FCA may have the best intentions to work together wherever possible, such as on authorisations, in order to avoid overlap and duplication. However the crux of the reform is to create two independent regulators. Despite sharing insights and analyses at a macro level, coordination on the ground might prove substantially more difficult to achieve. There is a real risk of independent visits and approaches, and a divergence of agendas over time.

'...the PRA's challenge centres on the sustainability and resilience of each firm's entire business model.'

While the FCA's challenge is to pre-empt issues relating to new products and distribution channels, the PRA's challenge centres on the sustainability and resilience of each firm's entire business model. This overlap, yet fundamental difference, in the scope and statutory objectives of the two regulatory bodies will ultimately mean two separate agendas with firms.

The changes afoot are far more significant than simply amending the name on the door at Number 25, The North Colonnade.

Financial institutions must stand back and think through their entire business through the lens of the new regulators. This includes strategy, business model, customer products and services, distribution, processes, risk appetite, governance and controls, and their overall impact on the financial system. Viewing the situation as 'more of the same' may leave them exposed to a rude awakening.

Jon Pain
Financial Services Regulation
Partner, KPMG

MiFID II: what investors think

The Markets in Financial Instruments Directive review, or 'MiFID II', will attempt to correct some unintended consequences of MiFID, including the increased opacity created by the fragmentation of trading activity across European venues.

However, interviews with heads of equity trading at global asset management firms – by financial research and consulting firm Aite Group – have revealed concerns about some of the proposals. This article summarises the key findings of Aite Group's report, *Key Aspects of MiFID 2: Asset Managers' Views*, which focuses on four areas of equity market structure: high-frequency trading, the consolidated tape, broker-crossing systems and deferred publication.

HIGH-FREQUENCY TRADING

Regulators are becoming increasingly focused on the impact that high-frequency trading (HFT) is having on market efficiency. This started with an accurate definition of HFT, followed by asking HFT firms to register so that their activities can be properly scrutinised. However, some of the European Commission's suggestions will increase trading costs for hedge funds and asset managers. These unwelcome additions include a minimum period that orders must rest on the order book before being cancelled, and a form of market-maker obligations for firms that conduct a significant amount of trades in a given stock.

Many buy-side firms said that regulators should focus on tackling market abuse. Rules already prohibit firms from front-running, where a broker trades an equity based on information from an analyst that is not available to the market, and from quote-stuffing, which

refers to flooding the market with data to overload competing computers. However, no regulator in Europe has issued a fine for quote-stuffing.

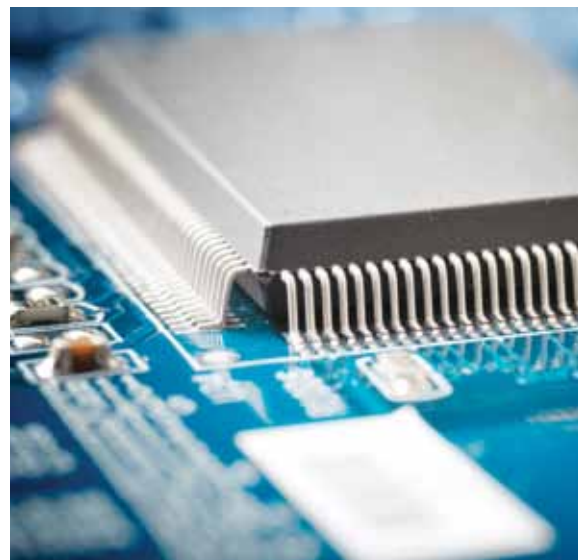
EUROPEAN CONSOLIDATED TAPE

The creation of alternative trading venues under MiFID has not only fragmented European liquidity, it has also obscured market data, as firms report trading activities to multiple venues. The London Stock Exchange's share of all trading in the FTSE 100 has dropped from 99% to 58% since MiFID was introduced at the end of 2007, according to Thomson Reuters' Equity Market Share Reporter. There are now 16 venues in Europe where FTSE 100 stocks can be traded. As a result, some trades are reported at up to three different venues, leaving traders confused about the amount and location of liquidity in the markets.

Every buy-side trader interviewed expressed a need for an accurate post-trade picture, but there is disagreement about the right reporting standards. The regulator must therefore intervene to provide and enforce these standards.

BROKER-CROSSING SYSTEMS (BCSs)

The use of trade crossing services, where brokers execute opposing client orders without going to the market, has grown since the electronification of crossing and the implementation of MiFID. The Commission now proposes that all electronic crossing networks, defined as organised trading facilities (OTFs), should convert into multilateral trading facilities (MTFs), venues with higher levels of transparency, once specific trading volumes are reached.



Those surveyed unanimously agreed that a regulatory category for broker-crossing systems is appropriate. However, they said that the conversion of a BCS into an MTF would have a negative impact on trading strategies and increase costs.

DEFERRED PUBLICATION

The Commission proposes to amend the deferred publication regime, which allows a maximum of four days to unwind large block positions before reporting them to the market. Instead they would have to report by the end of the trading day.

This is not welcomed by most asset managers as it will increase the cost of trading large blocks, particularly trades of illiquid stocks. One buy-side trader stated that 'increased trading costs will deter asset managers from taking large positions in small- and mid-sized enterprises', making it harder for small and medium-sized entities to raise capital – the primary role of any financial market.

Simmy Grewal
European analyst, Aite Group



FINANCIAL SERVICES FACULTY AUTUMN 2011 SEMINARS

FOCUSED SUPPORT FOR A CHANGING WORLD

REPORTING BY FINANCIAL SERVICES FIRMS: A ROUND-UP OF IASB CHANGES

Thursday 15 September, 08:30–10:30

Take the opportunity to find out what the IASB's recent activities mean for your financial services firm. If you audit or provide advice to a financial services client, this update will be very relevant to you.

BASEL III WORKSHOP: IMPLEMENTATION GETS UNDERWAY*

Wednesday 28 September, 08:30–17:00

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* Includes membership to the Financial Services Faculty.

See website for further details.



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Rethinking market risk reporting



Financial institutions discovered the weaknesses in their market risk frameworks the hard way in 2008. Value at Risk (VaR) models and market risk stress tests used by a number of the large investment banks failed to pick up warning signs prior to the crisis, which allowed dangerously high levels of risk to build up in the financial system undetected.

The banks' experiences during the market turmoil, along with the increased regulatory scrutiny and higher capital requirements that followed, led many institutions

to rethink, and often redesign, their market risk processes, controls, models, governance and supporting IT infrastructure.

'The revision of market risk operating models and risk frameworks was long overdue...'

This article, the second in a series on risk reporting in *FS Focus*, focuses on the implications of these developments for market risk reporting in the banking industry.

LESSONS LEARNED

The revision of market risk operating models and risk frameworks was long overdue, given the substantial changes to the banking environment over the past decade, due to the creation of increasingly complex financial products, geographic expansion, increasing trading volumes and rising risks.

One of the major changes since the financial crisis has been a fundamental overhaul of the way market risk is measured, precipitating a move away from an overreliance on VaR, a model that attempts to measure the risk of loss on a portfolio of assets.

Although VaR captured most of the banks' risk positions, it failed to account for a significant portion of them. A couple of examples of this are basis risk, which results from differences in the market performance of two similar positions, and gap risk, which occurs when there is a sudden jump in the price of a financial instrument. Moreover, its underlying assumptions do not necessarily hold in crisis situations.

The VaR models and market risk stress tests used by a number of the large investment banks did not account for the interconnection between firms and markets, which can produce self-reinforcing cycles. This can lead to a situation where so-called 'systemic risk' is highest when VaR is at its lowest, which in turn encourages behaviour that creates systemic risk.

Another lesson learned is that greater flexibility is needed to manage risk effectively in a crisis situation. This is needed to perform

NEW BASEL 2.5 RULES AND GREATER SCRUTINY

The most forceful driver of change has been the new rules detailed in the Basel 2.5, which significantly increase the amount of market risk capital that institutions must hold to account for stressed market conditions and credit risk in the trading book.

This affects banks that must gain approval for the internal value at risk (VaR) model used to calculate the regulatory capital charge on their market risk trading book. These rules are partially in force in some jurisdictions and will need to be implemented in others.

Key additions to the 'old' VaR capital charge are:

- stressed VaR – a charge to account for potential losses in stressed periods
- Incremental Risk Charge (IRC) – an additional charge for their traded debt instruments
- Comprehensive Risk Measure (CRM) – additional charge for losses in correlation books.

Some regulators also require institutions to monitor and report on 'risks not in VaR' (RNIV) regularly and to hold an additional capital cushion against them.

Concentration risk, market liquidity and tail risk (and hence stress testing frameworks including reverse stress testing) are all coming under increased regulatory scrutiny, due to the need for independent validation of market risk models.

ad hoc analysis and to be able to produce and report results rapidly to the business, senior management and regulators across a number of different jurisdictions. Many banks found that poor systems infrastructure prevented them from readily carrying out the required analysis.

'To make significant improvements, banks must reassess their whole market risk measurement framework...'

RISK REPORTING CHANGES

Risk reporting is a crucial element of an effective market risk management framework, as it provides risk exposure information and as such forms the basis for effective controls and decision taking. Risk reports have also had to evolve to meet rising regulatory expectations, adding to the complexity of market risk reporting frameworks.

Reports must now show market risk exposure at different levels of aggregation, including the global organisation, legal entity, each business line, asset class, portfolio and for the trading and banking books. The reporting

framework must also show a range of market risk measures relating to risk sensitivities, VaR, economic capital, scenario and stress-testing exercises, and these numbers must be compared against risk limits with limit breaches clearly labelled.

The content and frequency of a risk report depends on its purpose and has to be tailored to the needs of its audience. In a trading environment, for example, there is a clear requirement for the real-time calculation of a range of key risk numbers, which are needed for ad hoc analysis and reporting, as well as for comprehensive daily market risk reports.

Weekly reports contain a summary of the risk exposure numbers alongside a market overview, and explanations of changes to risk profiles together with an identification of large exposures or concentrations and limit breaches. In the past, by contrast, reports were less holistic and often difficult to interpret.

Our view is that monthly senior management board reporting has also improved, and now usually consists of aggregated risk exposures (for example, by group and division) set against limits. These reports also give a market overview, high-level explanations of changes to risk profiles and a summary of group-level breaches of risk limits.

FURTHER REFORMS

A number of institutions have started to rationalise their market risk reports, establishing where there are reporting gaps and overlaps and streamlining their reporting framework. The quality of reports, however, largely relates to the comprehensiveness and accuracy of content and timeliness of the report. This is directly linked to the appropriateness and rigour of the underlying risk models, the availability and quality of data, and the functionality of risk systems. While lots of tactical solutions have been developed, the robustness of reporting frameworks still needs to increase across the industry. Underlying systems and databases should be streamlined to enhance data consistency and quality. Manual intervention by financial institutions in the production of their risk reports leads to errors in the content and absorbs risk managers' valuable time, which could be better spent on risk analysis and control.

To make significant improvements, banks must reassess their whole market risk measurement framework: risk models must be revised, systems must be enhanced and data quality must be improved.

Banks should not concentrate their efforts entirely on the enhancement of existing VaR models; greater emphasis on stress testing and scenario analysis would help to measure risks that VaR, by design, does not capture.

For example, there must be greater emphasis in future on models that include the risk of losses under extreme market conditions, or 'tail events', a dry-up in market liquidity, or contagion effects, such as the current eurozone crisis.

On a cautionary note, however, it is worth remembering the difficulty of designing models to capture the behaviour of unknown future market dynamics.

Sonja Koerner

Partner, Financial Services Risk,
Ernst & Young

Is internal audit fulfilling its role at central banks?

There has been increasing awareness of the important role that internal auditing plays in monitoring and improving the governance, risk management and control processes of central banks across the world.

This was highlighted by the International Monetary Fund (IMF) in its 1999 review *The Role of Internal Control and Audit Systems in Supporting Central Bank Governance and Transparency*. The review argued that it takes more than 'a sense of public duty' or 'mere will' to achieve high standards of corporate governance. Instead it requires a mechanism, such as an internal audit system, to assist management in controlling behaviour and risks and to help meet the bank's objectives.

The role of internal auditing at commercial banks has also drawn the attention of the Basel Committee on Banking Supervision (BCBS). It published the results of a survey into internal auditing at 71 banks across 13 countries in 2002, which found that the scope of internal audit was broadly consistent with the Institute of Internal Auditors' (IIA) definition.

'...an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations...'

The IIA characterises the function as 'an independent, objective assurance and consulting activity designed to add value and improve

an organisation's operations. It helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.' This definition was set out in the *International Professional Practices Framework for Internal Auditing* (1999 and 2011).

RAISING GOVERNANCE STANDARDS

To date, there has been no published survey into internal auditing at central banks. However, it is recognised as a pillar of good governance and is encouraged as an important function in most of the 189 central banks worldwide, many of which have had an established internal audit process for a long time, and are accountable

to the Office of the Governor and an audit committee.

A recent IMF factsheet highlighted the need for a satisfactory report on the internal audit mechanism at a central bank before it can receive funds from the IMF. This is needed to provide assurance that 'the countries receiving its resources are able to adequately manage the funds', according to the document, entitled *Protecting IMF Resources: Safeguards Assessments of Central Banks* (2011).

The IMF factsheet argues that the internal audit function helps the central bank to evaluate and improve the effectiveness of risk management, control and governance processes. However, this depends on whether the function is effective, and whether the central bank has sufficient staff resources and organisational



independence to fulfil its mandate. The IMF assesses these factors and reviews whether the central bank's internal audit function complies with international standards as part of its due diligence process.

Another sign of the growing importance of this area are the well-attended annual training programmes aimed at internal auditors at central banks across the world. These include 'Effective Internal Audit for Central Banks', organised by Incisive Media, and the 'Heads of audit forum' offered by the Bank of England Centre for Central Banking Studies.

'...there should be no difference in the professionalism of internal auditing at central or commercial banks...'

DIFFERENT OBJECTIVES?

Arguably, there should be no differences between the requirements for governance in central banks and commercial banks.

The principles of accountability, integrity and transparency set out in the Cadbury Report, published in December 1992, lie at the heart of both types of institution and form part of the code of governance of every nation. Similarly, there should be no difference in the professionalism of internal auditing at central or commercial banks in their promotion of compliance with regulation, cost-effective controls and continued improvement.

That said, central and commercial banks have different objectives. Compare the Bank of England (the Bank)'s mission 'to ensure monetary stability and to contribute to financial stability' with the following excerpt from the mission statement of a large bank in the UK: 'Our customers and clients are at the centre of our strategy and business model. Putting their needs first is essential to developing a long-term sustainable business.'

Central banks are driven by a need for continuing monetary and financial stability; commercial banks are driven by a need to satisfy their customers, to be profitable and to remain solvent.

DIFFERENT SKILLS?

So, although the necessary controls over financial transactions may be similar for all banks, the public policy goals of central banks may throw up issues not found in the commercial sector.

Some of these unique challenges include auditing of analytical functions, providing assurance about decision-making and the implementation of monetary policies, the stability of financial systems and the security of banknote production and distribution.

In addition, central banks in some nations are responsible for monitoring the relationships that supervisors have with banks and other financial institutions and, in some cases, they are directly responsible for that supervision.

The existing international standards for professional internal auditing are an appropriate guide for central banks carrying out such

a supervisory role – they set out the structure, skills, quality of practices and ethics required of the internal audit function. This will be added to the scope of internal auditing in the Bank as a result of the new responsibilities of the Prudential Regulatory Authority.

There will also always be differences between the size of internal audit functions in central banks and other banks. Most central banks have small internal audit functions operating nationally, which contrasts with those at banks operating with large global functions.

The approach of each central bank will also vary depending on the particular monetary, financial and sustainable banking objectives in each nation, and the legislative and regulatory environment in which it operates. This will affect its mission statements, strategic goals and business focus. It will also be reflected in the different governance, supervisory responsibilities and compliance regulations that exist for central banks and for banks.

All internal auditors in central banks should reflect on the following comment by Sir Mervyn King, Governor of the Bank, in his recent Mansion House speech on 15 June: 'The Bank must be fully accountable to Parliament and the public.'

The disclosures that a central bank makes in its annual report are important for public accountability, and internal audit should aid this process by providing independent assurance about the effectiveness of the bank's internal controls, risk management and governance processes.

The Bank's 2011 annual report states that internal auditing should assist its Court of Directors and executive team to protect the Bank and its reputation – an excellent benchmark for all central banks and their annual reports.

Jeffrey Ridley
Professor of Auditing,
London South Bank University



Is UK distribution reform the right model?

Most advisers are keenly aware of the waves of change sweeping through the financial services industry. Changes to savings patterns, an overhaul of the delivery of state and private pensions, the Retail Distribution Review (RDR) and the platform consultation are all coming at once.

Taken together, these changes mean that those on lower incomes will probably be better served through state and employer-sponsored savings, while those at the top will need more advice than ever. Advisers will need to position themselves to demonstrate why clients should pay for their advice.

THE INTERNATIONAL CONTEXT

Some countries have come up with a range of different measures to address what they see as inherent market distortions or exploitation in distribution models. Others, however, see these reforms as

threats to a key industry. Global regulators are carefully watching developments in the UK, partly curious to see if opponents of the reforms succeed in getting them watered down.

There is less of a consensus about the professionalism and qualifications side of distribution reform. For example, Australia supports grandfathering – this exempts commissions and incentives paid for financial advice given before there was a change in the rules. Other countries are paying most attention to commission reform, but UK reforms could arguably have a much greater impact over the long term.

THE UK – BECOMING A NATION OF SAVERS?

The credit crunch spelled the end of unsustainable borrowing in most of the developed world. The hope that the inflation of asset prices,

particularly in the property market, would pay for borrowing has been dashed. We may be seeing the beginning of a generational shift away from borrowing as a result. The availability of mortgages and the attractiveness of buying houses will probably continue to diminish. This should lead to a far higher proportion of saving in future, and fewer people on means-tested benefits. A host of industry changes and financial reform, such as auto-enrolment into workplace pensions, are reinforcing these changes.

At the lower end of the market, debt counselling will no doubt become increasingly important, and is a service that can't be offered on a commission basis.

'Advisers will need to position themselves to demonstrate why clients should pay for their advice.'

RADICAL PENSION REFORMS

For many people, savings decisions will be clearer, or at least fairly automated. After 2014 auto-enrolment, more people than ever will have access to an employer pension with the employer contributing. For those on a lower income, along with the availability of a simple default pension savings plan with the National Employment Savings Trust (NEST), this will be their main source of long-term saving.

Some of the funds that people on lower incomes end up in, whether through NEST or an employer

INTERNATIONAL ACTION

US – the US regulator hasn't intervened directly, but after the tech bubble burst, many large firms moved to fee-based business models focusing on asset allocation. This has been attended by a continued slide in asset-weighted mutual fund prices.

India – India became the first country to ban initial commissions by mutual fund providers. In the process it left a gaping loophole because it didn't ban unit-linked life fund commissions. The Financial Services Authority (FSA) has kept this in mind, as it wants to avoid creating this type of regulatory 'arbitrage' as an outcome of RDR.

Australia and the Netherlands – both countries are introducing RDR-like reforms in the next few years. The Netherlands is also banning commissions on mortgages and insurance.

Other European countries – the European distribution model is bank based and commission driven so there is concern that the EU will follow the UK's lead. European advisers perceive this as a major threat to their business models.

scheme, will include elements of 'embedded advice', such as target-date funds that automatically adjust portfolio allocations as investors approach retirement. The combination of 'embedded advice' and employer contributions will significantly reduce this group's need for advice, something that is conveniently forgotten by those who attack RDR on the grounds that it will deprive low-income earners of financial advice.

Those within lower income brackets will potentially have more wealth in retirement, with a simplified higher state pension, even if they do have to work longer to get it.

SIMPLICITY FOR SOME, COMPLEXITY FOR OTHERS

Those higher up the income scale, however, could face more complexity and require more advice on a fee basis. The end of defined benefit pension schemes means lower employer benefits for private and public sector staff. At the same time, they will have more savings and investment options with more platforms, and a greater range of products and scope for drawdown throughout retirement.

This sector of the market has the greatest means and motivation to seek and pay for unbiased advice from highly professional and qualified advisers.

Fee-based advice, with the investor in the driving seat, has every chance of thriving in this environment. Banning commission and boosting requirements for qualifications and development will give investors greater confidence that the advice they get is impartial and sound.

Advisers will focus more on the high-net-worth segments. The wealthy may only be 30% of the population but they have over 80% of the wealth (see the table, 'A breakdown of UK wealth', below). There are 2.6 million households in the top 10% band alone, according to the Wealth and Assets Survey by the Office for National Statistics (2006–2008). That's arguably enough for all the fee-based advisers, based on Vanguard assumptions of 150 to 200 clients for each of the expected 15,000 firms post-RDR.

All advisers must put in place new systems and processes, focused on their clients' needs, in a fee-based world. This had already begun before RDR but it has much further to go. Whether other countries will pursue similar distribution reforms, however, remains to be seen.

Peter Robertson
Head of Retail, Vanguard Asset Management



A breakdown of UK wealth

DECILE	INVESTABLE WEALTH*	% HELD
1	2,448,300	54
2	856,800	19
3	508,400	11
4	303,200	7
5	181,000	4
6	112,800	2
7	75,200	2
8	31,700	1
9	5,000	0
10	-8,200	0
Total	4,514,200	100

84% of the investable wealth in the UK is held by the top 30% of households, with more need for advice from fee-based advisers.

Those on modest incomes, 70% of households, hold only 16% of wealth. They will be better served as a result of pension reform, with a lower requirement for advice.

*Net financial pension wealth, excluding physical and property assets. 26 million households in total at time of study, divided into 10% bands (2.6 million each).

Source: Wealth and Assets Survey, Office for National Statistics 2006–2008.

Investment suitability demystified

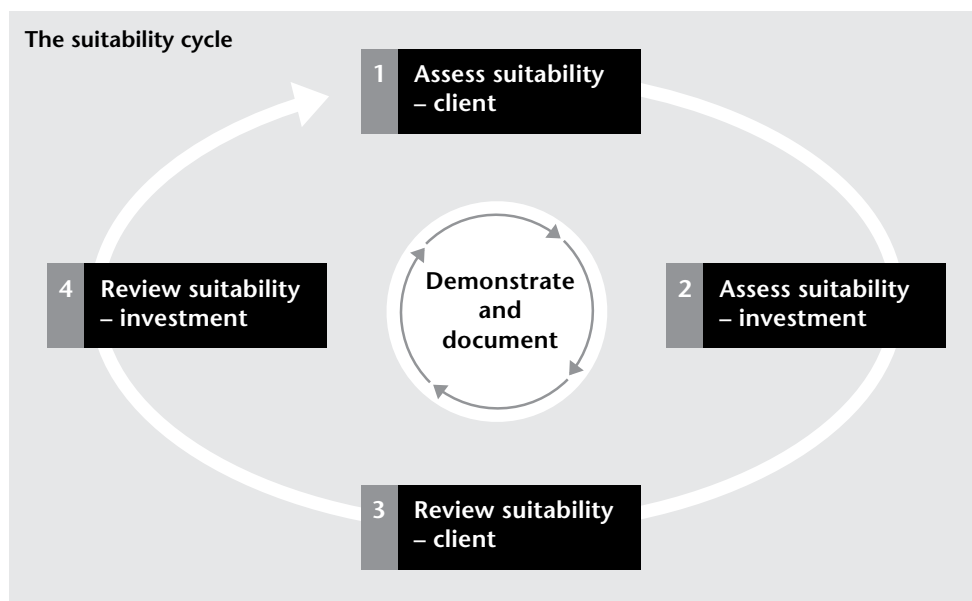
Suitability is a continual cycle of assessment and review at both client and investment level. The definition of 'suitability' is not clear-cut and in the avoidance of risk there is a danger that we, as investment advisers, are drawn into taking an overly cautious or passive approach to investment on behalf of our clients, whether making personal recommendations or managing investments.

ASSESSING CLIENT SUITABILITY

The cycle usually begins with the introduction of a new client and an assessment to determine his or her risk appetite. Many of us will have considered the use of risk-profiling tools. Notwithstanding the benefits they bring to the suitability assessment process, however, their limitations mean that we must still use our professional judgement to validate each client's risk profile. Our fact-finding exercises, however styled, must therefore be clear, robust and relevant but still allow for that professional judgement to prevail.

A new client's present and expected financial circumstances drives our assessment of their capacity for financial loss, while their understanding and experience shapes their willingness to accept loss.

As discretionary fund managers, our explanation of risk must be tailored to each personality as investments should, after all, provide comfort to the client rather than raise concern. We must recognise our responsibilities as appointed investment experts, yet we must ensure that clients individually have enough information and understanding to appreciate the potential risks they are taking.



It is often a process of education, but without the benefit of an examination pass mark to provide evidence that each client has truly understood the principles behind investment risk.

'As discretionary fund managers, our explanation of risk must be tailored to each personality as investments should, after all, provide comfort to the client rather than raise concern.'

ASSESSING INVESTMENT SUITABILITY

The next step in the cycle is an assessment of investment suitability. This is where the involvement of an independent financial adviser (IFA) is so valuable. An IFA can bring a far more holistic view, and therefore greater understanding of a family's financial requirements to our consideration of an investment

solution as part of the discretionary fund management service.

The assessment of the suitability of investments sits firmly with all investment advisers. A robust investment process needs to be well and expertly resourced. An in-depth due diligence process must be used to: consider the correlation across different assets; identify the true corporate or single counterparty exposure; measure the quality of the equity content (not just the percentage weighting held); and judge the transparency and realistic liquidity of the investment in different market scenarios.

Analysing the reasons behind performance dispersion and the structure of commonly used benchmarks is crucial, but often disregarded. There can be a failure, for example, to appreciate just how insignificant the UK's market capitalisation has become in relation to the value of global equity markets, and that around 50% of the constituents of the FTSE All-Share Index come from just two sectors.

Having carried out in-depth due diligence and set strategy for expected market and economic conditions, model portfolios can then be used to develop a centralised view of the best way for investments to be blended. They can also be helpful to promote consistency across an investment department and stimulate challenge and debate. This promotes sound portfolio construction, diversification and, ultimately, suitability. The subsequent reviews of suitability are constant, responding to the changing personal circumstances of our clients and the dynamic investment environment.

REVIEWING CLIENT SUITABILITY

This stage of the cycle should be regular. It can be all too easy to assume that no news means that circumstances have not changed and that our clients are satisfied with the investment service they are receiving.

Time can soon elapse, and reporting serves an important prompt for discussion, but personal contact is crucial for us to make our professional judgements – just as at the initial fact-finding stage. Meetings are not always appropriate, and telephone calls often feel inconvenient or awkward for the client, but the resulting feedback is vital for ongoing confirmation that our assessment of client suitability remains correct.

REVIEWING INVESTMENT SUITABILITY

The control, monitoring and challenge of any assessment made is the next stage in the cycle. It is particularly important where we are relying so heavily on personal judgements. Again, model portfolios can assist as a benchmark for portfolio construction, while the better use of IT can facilitate appropriate management information and review mechanisms. Finally, but critically, robust documentation is central to the whole suitability assessment cycle.

Paula Forecast

Director, Jupiter Private Clients and Charities



‘...personal contact is crucial for us to make our professional judgements...’

Managing the regulatory burden

Financial services firms have faced a rising regulatory burden and the prospect of yet more intense scrutiny since supervisors began to get to grips with the causes of the financial crisis.

Judging by the words of Hector Sants, Chief Executive of the Financial Services Authority (FSA), that trend shows no sign of abating. Speaking at the launch of the Financial Conduct Authority (FCA) in June, Sants said: 'The failures of the past ten years mean that change is essential. We have a once in a generation opportunity to shape the new regulatory structure and challenge past orthodoxies. We must not waste it.'

As a result, the costs of compliance look set to continue to rise, with higher direct regulatory fees, increasing compliance salaries and expanding compliance departments. Some of the Financial Services Compensation Scheme (FSCS) levies rose by 1,000% in 2011 compared with last year. Although this is an extreme case, it may well mark the trend for the future.

In addition, the industry has a number of regulatory initiatives on its plate. Firstly, there is the new macroprudential regulatory regime. Banks and insurers are preparing for greater intervention from the new Prudential Regulation Authority under the control of the Bank of England. Secondly, there is the role of the new FCA, which will be looking at the structure of the financial advisory market and overall behaviour of market participants.



'...the costs of compliance look set to continue to rise, with higher direct regulatory fees, increasing compliance salaries and expanding compliance departments.'



And then, over the next 18 months, there will be Basel III, the Retail Distribution Review (RDR) and Solvency II to contend with.

THE ROOT OF THE PROBLEM

So why do we find ourselves in this situation? Part of the explanation is the rebound from the financial crisis, but also the fact that regulation is maturing and becoming more consumer orientated. As recently

observed by Dame Deirdre Hutton at the FCA launch, the industry has lacked a sense of urgency and has not really moved with the times in comparison with other heavily regulated sectors, such as food and aviation. A key component in the FSA's consumer protection strategy is to identify risks earlier, proactively intervene earlier in the product chain and prevent consumer detriment.

The increased intervention of the regulator is understandable, given the number of issues that have already caused consumer detriment, or which threaten to damage consumer interests in the future. Some of the issues that are currently raising alarm bells include: unfair terms in mortgage contracts, such as the treatment of mortgage customers in arrears, and the period given to customers to sort their finances before the lender decides to take formal action; the sale and marketing of structured investments and deposits; and complaints handling in major banks and payment protection insurance (PPI).

These issues, and others, have tended to arise from changes in either the business model or behaviour of firms, or to have resulted from product innovation, which has in many cases increased product complexity.

MANAGING THE COMPLIANCE BURDEN

In this environment, firms must comply 'smarter' with regulatory responsibilities. Simply being risk-focused is rather old methodology and wasn't of help during the crisis. The new focus for firms must be on outcomes – in other words, all firms, whatever their shape, size, sector or specialism, must consider the impact of their activities.

Firms may be suffering from fatigue as a result of their efforts to embed the 'Treating customers fairly' principles within their businesses, but an outcomes-focused approach really gives them the opportunity to be creative with their risk management and compliance strategies.

If firms can embed compliance within their business lines through a change in culture, this can be a far more efficient approach, compared with the high costs of having a large centralised compliance function. However, there must be close control over responsibilities and clear key performance indicators,

'The new focus for firms must be on outcomes – in other words, all firms, whatever their shape, size, sector or specialism, must consider the impact of their activities.'

as well as a change in mindset to ensure that compliance concepts are truly embraced by the business.

Firms need to see compliance as a driver of business quality, which does not simply mean the protection of reputation. It also involves building reliable and respected brands – good compliance is good for business. This may take time before it is fully understood. We should be under no illusions about what is involved in turning around an industry's reputation. It does not happen overnight, but then look how the food industry has moved on from the BSE crisis of the 1990s – on the back of decisive action by the industry and regulators working in partnership.

Firms need to be more concerned with the quality of their compliance and risk management activities, and not just about the volume and value of their activities. As a result, the spotlight is turning to the performance of individuals within the functions of governance, risk and compliance.

OBSTACLES TO CHANGE

A number of recent 'Reports by skilled persons' (known as s166 reports) that we have been involved

with show the lack of impact that some compliance departments have when they are dealing with controls over conduct of business activities. These compliance teams tend to be either poor-performing, under-skilled or unmotivated.

At the root of the overall problem may be a perception at some firms that the role of the compliance department is 'business prevention'. In this situation, the compliance function does not command the necessary respect of the frontline business, and therefore spends its time fighting internal conflicts rather than tackling the real issues affecting the business.

We have recently seen a business go through an FSA investigation that led to a review of past business in order to deal with serious documentary weaknesses and concerns over the suitability of its investment product advice.

The investigation revealed that the firm: failed to collect and properly account for all the information relevant to assess the risk a customer was willing and able to take; relied too heavily on risk-profiling and asset-allocation tools; had poor descriptions of attitudes to risk; and failed to have adequate evidence to support the selection of suitable investments for the customer.

'At the root of the overall problem may be a perception at some firms that the role of the compliance department is "business prevention".'

However, through a customer contact exercise, a restructuring of its compliance and risk department, and the appointment of a board director as head of compliance, the firm has emerged from this episode with an improved regulatory reputation. It is also now a far less risky business that can clearly demonstrate how it treats its

PROBLEM AREAS

There is a worrying stream of poor conduct of business issues that is reinforcing the public's perception that the industry is lurching from one mis-selling episode to another. Some of the current problem areas include:

- the implementation of the Banking and Payments Regime, where codes of conduct based on principles and ethics have been put into place to provide balance, transparency and consistency of approach to the market. The FSA remains concerned at widespread disengagement of financial organisations and their responsibilities to consumers;
- strategies in the run up to the introduction of the RDR – ensuring that revenue maximisation does not lead to consumer detriment;
- weaknesses identified in the network model for advisers – concerns over the level of control and oversight that networks exert over their advisers;
- using platforms – monitoring the development of a growing market;
- firms' reward policies and practices – how firms control the risks that staff incentives may pose; and
- emerging product risks – these include traded life policy investments; exchange-traded products; self-invested personal pensions; and unregulated collective investment schemes.

There are also a number of potential concerns for the future including:

- the generation of income through fees in banking: developments in private banking and wealth management; protection products and possible PPI replacements; and packaged accounts, given the challenges major financial institutions have with their greater regulatory scrutiny around capital and liquidity requirements;
- risks associated with bundling products (eg, increased complexity);
- risks associated with cross-selling such as mis-selling and product design;
- new business models that may emerge as a result of the RDR; and
- tax changes and their implication for financial products, such as inheritance tax thresholds and capital gains tax limits for individuals, including capital gains tax reliefs for 'pension mis-selling' compensation. The reduction in the annual pension allowance to £50,000 from 2011/12 has meant many more individuals may become subject to an annual allowance tax charge, even after the introduction of the new carry forward rules, allowing any unused annual allowance from the three previous tax years to be carried forward.

customers fairly. While there has been some serious pain along the way, the actual restructuring has been relatively straightforward to implement.

TONE AT THE TOP

By raising the profile of the compliance department within the business, the board now understands the importance of the function and can set the right compliance tone, which cascades down throughout the firm.

Good governance sets the tone and values under which compliance becomes an integral part of the core business. However, those people in positions of significant influence

need experience, compliance know-how and access to advice from independent sources in order to be properly effective.

The Walker Review into corporate governance at UK banks called for greater high-level challenge within boardrooms. The development of ethical frameworks within the regulatory world and the increasing importance of professional standards perhaps give the financial services industry a once-in-a-generation opportunity to achieve this goal. Only time will tell.

Simon Collins
Managing Director, Resources
Global Professionals



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& Logistics

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AN ALTERNATIVE VIEW

TIME FOR A CORRUPTION CLAMPDOWN



Chandu Krishnan

Bribery and corruption are not victimless crimes. Corruption is hugely damaging and, in developing countries, has a disproportionate impact on those who are already living in poverty.

The 2010 Bribery Act, which replaces antiquated laws passed in the Victorian and Edwardian eras, gives the UK a robust instrument for combating bribery, both within the UK and overseas. It makes the UK compliant with its international obligations, particularly under the OECD Anti-Bribery Convention and the UN Convention against Corruption.

Financial services firms, like companies in other sectors, face particular risks when they operate in countries where corruption is endemic. Bribes paid to agents to secure contracts from foreign public officials, and the provision of extravagant hospitality to obtain business from clients would count as criminal offences under the Bribery Act.

In one recent case, the former chief executive of London-based insurance business PWS International was jailed for 21 months for making illicit payments of almost \$21m to Costa Rican officials between 1999 and 2002. And, in 2009, the Financial Services Authority fined insurance and risk management firm Aon £5.25m for failures in its anti-bribery and corruption systems and controls.

Investors providing foreign direct investment, debt and equity capital

or private equity funding need to ensure that they have adequate anti-bribery programmes and carry out due diligence for the risks of bribery on their investments.

Transparency International UK has prepared a consultation draft on its guidance for anti-bribery due diligence in mergers, acquisitions and investments. This encourages investors to adopt a 'best practice' approach in order to avoid legal liabilities and the potential financial and reputational damage that may come from investing in or purchasing a company associated with bribery. Companies should be adopting robust anti-bribery systems based on zero tolerance of bribery and corruption.

Other essential steps that all firms should take include: a thorough assessment of bribery risk; the adoption of effective anti-bribery policies and procedures; high-level attention awarded to the proper implementation of those policies and procedures; the application of due diligence to business partners; and continuous monitoring and review of anti-bribery systems.

The fact that the UK now has a strong anti-bribery law will make it easier for honest UK companies to resist demands for bribes and facilitation payments in overseas markets. It should also strengthen their hand in requiring their business partners to observe adequate anti-bribery standards. Drafted similarly to the US Foreign Corrupt Practices

Act, it will also enable prosecution of non-UK companies, particularly those who may be competing with UK companies and winning business unfairly by paying bribes. This creates a level playing field, as long as the UK and US authorities are willing to prosecute foreign companies – as the US has done several times in recent years.

The Act will enhance the UK's international credibility as a country that is serious about fighting bribery and corruption. Our exhortations to other countries – particularly developing countries – to improve their governance and pursue anti-corruption reforms were sounding increasingly hollow and hypocritical.

The UK will now be better placed to work with the OECD, the G20 and the United Nations to create a more level playing field for bribe-free international business. And this is crucial in three areas: promoting stronger enforcement of the OECD Convention by existing parties; encouraging emerging economies such as Russia, China and India to enforce laws against foreign bribery; and promoting effective implementation of the UN Convention against Corruption, which has been ratified by more than 150 countries and is the international community's most comprehensive, legally binding, global instrument to fight corruption.

Chandu Krishnan
Executive Director, Transparency International UK



UNFOCUSED

QUOTE OF THE MONTH

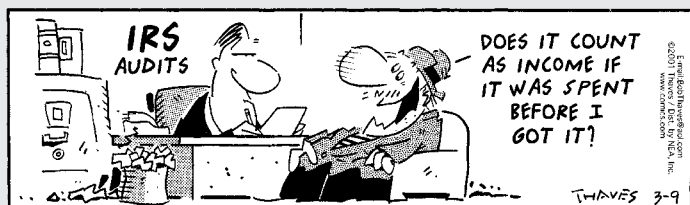
Treasury Select Committee (TSC) Chairman Andrew Tyrie got fairly tetchy in July after the Financial Services Authority seemed to reject 'in a peremptory manner' the TSC's call for a 12-month delay in the Retail Distribution Review, to give advisers time to comply. Speaking to *Money Marketing*, he said: 'The death of Parliament has been greatly exaggerated and this will not be the end of the matter. I have no doubt that when we next see Hector and FSA chairman Lord Turner this is an issue we will want to raise. We were very disappointed.'

TREATING CUSTOMERS RIDICULOUSLY

HSBC customer Josephine Lewis has won a civil case against the bank for harassing her with hundreds of, sometimes threatening, phone calls and unlawfully imprisoning her at a branch in Wootton Bassett in October 2008. Branch manager Chris Hicks barred her exit from a private interview room during a meeting to discuss overdraft fees, despite her pleas to leave. If a UK bank is prepared to stoop to the imprisonment of a customer in an overdraft dispute, Sir John Vickers, Chairman of the Independent Commission on Banking, will surely be wanted dead or alive later this year?

ROMANIAN-STYLE CAPITAL ADEQUACY

Europe's banks should count themselves lucky that the Basel Committee's capital adequacy ratios bear no resemblance to the kind of equity buffer required when taking a taxi in Romania. Two ICAEW members recently set out comfortably equipped with 300 RON (£62) for what they estimated to be a 30 RON journey to Bucharest airport. But in a twist of fate their driver demanded the full 300 RON for the trip. That's a Basel ratio of 900% by our calculation (potentially even more if you allow for risk weighting). The duo escaped with their capital buffer intact and a more sanguine view of the Basel ratios.



BOOK REVIEW



Reimagining Japan

Edited by McKinsey & Company

ISBN: 978-1421540863

Japan's economic prospects have been written off many times over the past 20 years as it has struggled with high debt, deflation and the need for structural reform. But *Reimagining Japan* provides fresh, and often contradictory, views from 80 authors about Japan's future.

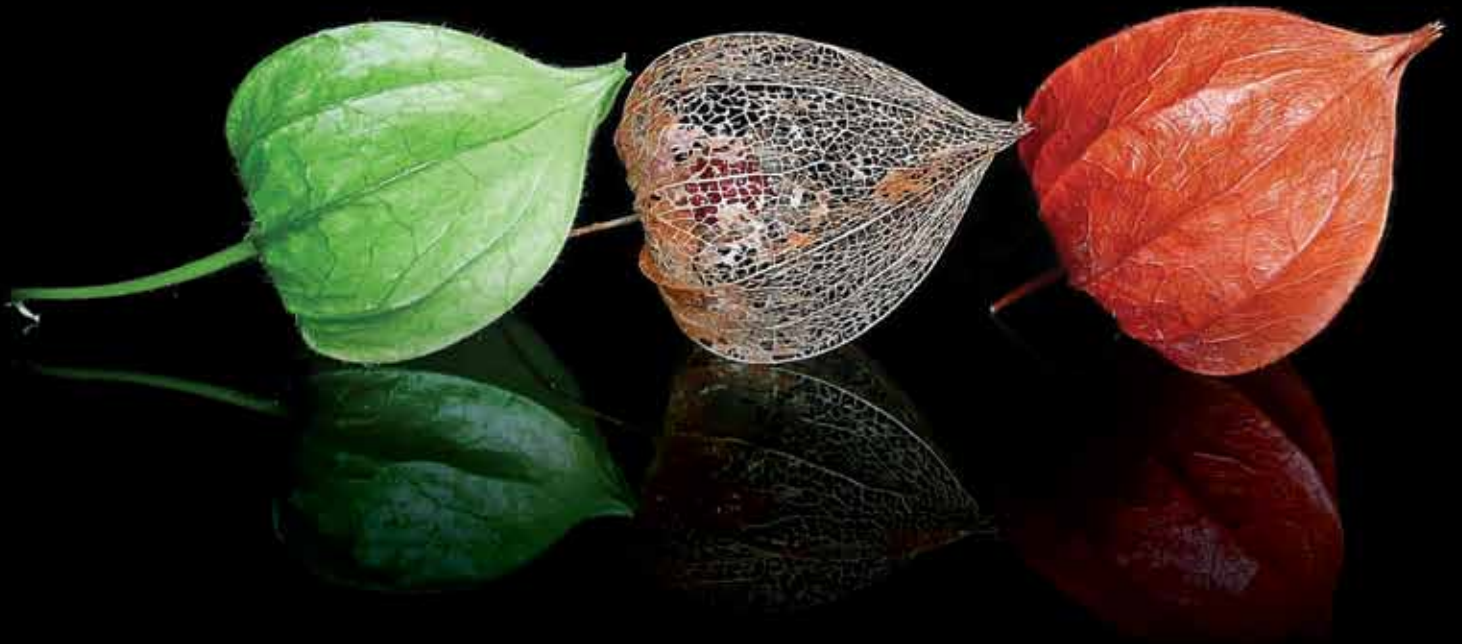
Significantly, many of the writers also highlight the parallels with the challenges faced in western Europe and the US. Stephen Roach, Non-Executive Chairman of Morgan Stanley Asia, warns that if the West continues to borrow from Japan's failed macro policies, such as quantitative easing and massive government borrowing, 'the greater the risk other countries will suffer lost decades of their own'.

Meanwhile, Adam Posen, a member of the Bank of England's Monetary Policy Committee and senior fellow at the Peterson Institute for International Economics, argues that 'the Japanese economy is becoming British' and that both countries may have to accept that their economic future will not be 'hugely exciting'.

No longer dominant players, both countries must recognise that their best hope lies with 'sensible macro-economic management, a stable world-class financial system, high flows of foreign direct investment in and out of the country, and the export of business services to accompany those investments'.

Many authors point to Japan's relationship with China, its biggest trading partner, as a source of optimism. But it will require freer competition, openness to collaboration and a less inward-looking approach in order to capitalise on this position.

As Takumi Shibata, Chief Operating Officer of Nomura Holdings, puts it, there will have to be a complete change in the current mindset, which 'encourages people not to take risks, not to make decisions, not to make enemies, and to stay in their organisations as long as possible'.



BASEL III: THE NEXT STAGE HOW DOES IT WORK?

BASEL III WORKSHOP – IMPLEMENTATION GETS UNDERWAY

28 September 2011, 08:30 – 17:00

Chartered Accountants' Hall, London

Basel III – the new regulatory framework for the banking industry – is now largely agreed. Implementation is underway. Broader in scope than Basel II, for example dealing with bank liquidity, the implications for business will be multiple and wide-ranging.

Sign up for our ICAEW workshop now to be fully prepared for the significant challenges Basel III is creating, and get the latest insights from leading experts.

Because of us, people can do business with confidence.



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