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Dear Zoe,

The Financial Reporting and Analysis Committee (FRAC) of The Chartered Financial Analyst Society of the UK (CFA UK) welcomes the opportunity to respond to the questions of the Parliamentary Commission on Banking Standards relating to tax, audit and accounting.

CFA UK represents more than 10,000 investment professionals working across the financial sector, the majority working as investors or on behalf of investors. For advocacy purposes in the field of financial reporting, members are represented by the Financial Reporting and Analysis Committee.

Panel on tax, audit and accounting initial questions
Financial Reporting and Analysis Committee (FRAC),
CFA Society of the UK
Response to Parliamentary Commission on Banking Standards' questions

Summary

Tax

- Tax-deductibility of interest payments creates an unlevel playing field between debt and equity that may encourage businesses of all types to rely too much on borrowing and too little on equity for their financing. Excessive borrowing does threaten the stability of the banking system, but easy availability of credit and the resilience of bank balance sheets are much more important factors.
- Two possible ways to level the playing field are to treat the expenses of raising debt or equity in the same way, and to follow the example of other countries that have thin capitalisation rules limiting tax deductibility of interest.

- Taxes should be simple and predictable. Some of the special measures taken to tax banks fall short of this principle. All companies have a duty to obey tax rules and HMRC has a duty to enforce them.

Accounting

- The most important point is that banks should have sufficient equity to absorb losses of any description, including the unexpected. This is a governance issue, overseen by prudential regulators. So the most important reforms are those already taking place to increase capital requirements substantially and to insist that banks have recovery and resolution plans.
- Accounting standards are being blamed for inadequate loan loss provisions, but the underlying problem was a lack of retained earnings to bolster equity and weak regulatory oversight.
- The accounts did show: rapid asset growth and sufficient information to prompt questions about the quality of those assets; suppression of equity, motivated by excessive focus on return on equity (RoE); and the growing use of short-term funding, which increased vulnerability to market turbulence.
- The hybrid accounting model, which measures trading assets at fair, or a current market, value and held assets at cost, is appropriate. It can aid bank resilience by phasing the recognition of losses.
- Fair value accounting only affected part of banks' balance sheets, and academic evidence has not indicated that it contributed to the severity of the crisis. Much more important was the deterioration in lending standards, notably where property was involved.
- Fair value is only a snapshot measure and it reflects the economic cycle. Users of accounts must be aware that current valuations are liable to change and they should treat changes in "paper" valuations with caution. It should be easier for users of accounts to distinguish gains based on changes in balance sheet values from gains realised in actual sales.
- Fair value accounting was in need of reform before the crisis to improve consistency of measurement and disclosure of assumptions. The three-level approach to fair value measurement, accompanied by disclosure of assumptions, is now adequate to deal with mark-to-market and mark-to-model valuations. So the focus must now be on rigorous and consistent application, with the auditors playing an important part in that.
- Users want a "true and fair" view of accounts and take that to mean an unbiased view of performance during the period and of the valuation of assets and liabilities on the balance sheet date. The use of IFRS does not contradict or diminish this concept – see the opinion of Martin Moore QC.
- In the absence of adequate equity build-up by banks, a move to an expected loss model may help by prescribing earlier provisioning for loan losses. But it has limitations: expectations are cyclical, forecasting is unreliable and banks are as liable to be caught out by the unexpected as the expected. Upfront provisioning may be used to smooth future earnings, detaching banks' accounts from the underlying economic reality.
- We do not need a separate accounting regime for banks. Standards dealing with financial instruments will be more heavily used by the financial sector, but the same instruments and activities should be accounted for in the same way

whatever company is concerned. Otherwise opportunities will be created for regulatory arbitrage.
- It is important that investors can understand banks' accounts and compare one sector with another. Creating a separate regime would make this more difficult.

Auditing

- We expect auditors to exert discipline on management in a number of ways, including ensuring that the accounts present a "true and fair" view and that accounting standards are applied consistently. This includes checking that valuation methods are appropriate and rigorous. We do not think it is right to describe this as "box-ticking".
- The restoration of dialogue between auditors and prudential regulators is a good thing. Other engagement, for instance with investors, might also be useful, although client confidentiality and insider trading rules would limit these exchanges to thematic issues.
- The audit report should be more helpful, for instance on the difficult judgments that have to be made. So far this additional information is being provided via the audit committee report, which we must assume the auditor agrees with.
- The inherent problem is that the company hires the auditor, so users of accounts have to discount for this potential conflict of interest. If investors want a separate, independent report on the accounts from the auditor, the model would need to change to one where they pay directly.

Detailed responses to the questions

1. How, if at all, does the tax system encourage leverage in banks? What is the effect of having tax relief for debt interest but not for dividends on equity? What effect does this have on the stability of the banking system?

1. Tax relief on interest payments may incentivise banks and other companies to increase leverage. It does create an unlevel playing field, however, debt and equity are different parts of the capital structure; and there may be advantages for businesses in the reduced cost of capital caused by tax deductibility of interest. Leverage only has an impact on stability of the banking system if, in combination with other factors creating easy credit, it leads to over-borrowing. Even if the playing field were level, prudential and systemic regulators would need to watch out for over-borrowing by businesses and individuals, and for the risk of catastrophic loan losses at banks in a downturn. Banks' resilience in these circumstances depends on the level of loss-absorbing capital they hold.

2. What are your views on alternative systems to level the playing field?

2. Corporation tax could be applied higher up the profit and loss account, such as on operating profits (EBIT). Alternatively, dividend payments could be made tax allowable for the company and/or tax exempt for all recipients. However, treating this form of income more favourably than other income has caused some problems for the tax authorities. The playing could be levelled in one way by applying the same

tax treatment to the expenses incurred in debt and equity raising eg allow deductibility for the latter. Since over-leverage is the underlying cause for concern, it would be worth considering the "thin capitalisation" rules applied in some countries, which limit tax-deductibility according to measures of gearing or interest costs.

3. Do banks' attitudes to tax planning affect banking standards and culture, and does this have any effect on the wider economy?

3. Problems with standards and culture have been exposed in recent years, but banks' attitude to tax has not been a major factor. All companies have a duty to obey tax rules and HMRC has a duty to enforce them. This should mean that transgressions only affect the reputation of the company concerned, not the whole sector. It is worth noting that recent tax controversies have involved non-financial companies.

4. It is bad for the economy that the reputation of banks (on which other businesses rely) has been tarnished by taxpayer bailouts of insolvent institutions and other scandals, including mis-selling of PPI and LIBOR rigging. Issues to do with tax planning have probably affected accountancy firms more than banks, which have been considerable contributors of both corporation and income taxes.

4. Do you have any views on the role and purpose of structured capital markets teams in banks? Does the volume and type of structured tax transactions have any effect on bank stability, and did this play a part in the banking crisis?

5. SCM teams play a significant part in banks. Although they may work on tax efficient structures, they do provide a valuable service in providing entities with funding opportunities. Additional sources of funding can add to stability. If SCM type trades are perceived to be tax evasion, rather than legal means of achieving tax efficiency for savers and businesses, this may create reputational risk. The key is enforcement of tax laws and for banks to manage the risks within these departments appropriately.

5. What are your views on the effectiveness of the Code of Practice on Taxation for banks? Would the Code benefit from having sanctions and if so what should these be?

6. The Code is clear on the way banks should behave. Its impact on behaviour is rightly being monitored and HMRC must ensure it is being observed. The Government is planning to introduce a General Anti-Abuse Rule, providing another enforcement tool.

6. How effective has the Senior Accounting Officer legislation been with particular regard to banking standards and culture?

7. HMRC has released revised guidance and is no doubt continuing to monitor. CFA UK has no particular knowledge of the way this is working within banks.

7. Do we need a special tax regime for banks? If so, what would this look like and what would be priorities for change? Should tax continue to follow accounting with respect to banks? Should the tax system actively seek to influence banking standards and culture?

8. It is unusual to single out a sector for additional taxes, and generally not desirable. Taxes should be simple and predictable, but some of the special measures taken to tax banks fall short of this principle. The balance sheet levy, set at £2.5bn, has seen the rate adjusted to achieve this out-turn, but this approach reduces the predictability of tax rates. While one justification is to compensate the taxpayer for the cost of the crisis, the impact on bank profitability and rebuilding of equity may be counter-productive.

9. A related issue is the funding of the Financial Services Compensation Scheme (FSCS), which could switch to a partly pre-funded, risk-adjusted arrangement, more like the US FDIC regime. Any risk adjustment should be formulaic to aid predictability.

8. Are banks exploiting regulatory and information arbitrage between FSA, HMRC and auditors? If so, what is needed to address this?
Is there any evidence of this?

9. Should there be a 'safe environment' in which the tax authority, regulator and auditors can share confidential information and concerns, possibly on varying levels of seniority?

10. Such a 'safe environment' already exists in that communication between the prudential regulator and auditors has been revived. We would not expect the tax authorities to have any difficulty communicating with the regulator. Issues of client confidentiality are likely to make meetings between tax authorities and auditors thematic (rather than inquiring into the behaviour of specific institutions), unless HMRC has evidence of wrongdoing. Users of accounts would be very interested to have access to the content of such exchanges, but we accept that certain information will not be made public.

10. What was the role of accounting standards and reliance on fair value principles in the banking crisis? What does a 'true and fair view' really represent to the market?

11. Banks' accounts did not rely on fair value principles. They are based on a hybrid model: trading assets are marked to market, as one would expect for things designed to be bought and sold; assets designed to be held to maturity, eg loans, are accounted for at cost under conventional amortisation and impairment rules. IFRS 9 represents an improvement over IAS 39 by simplifying the classifications and aligning them better with the business model. In the crisis, the accounts recorded first the falling value of trading assets and then (and this is still going on) loan losses arising from the subsequent economic downturn. Sometimes this difference in accounting aided the banks' resilience, notably when the value of trading assets recovered before loan losses were booked. Where banks, eg in continental Europe,

reclassified assets to avoid having to mark to market, it could be argued that they were not offering a true and fair representation.

12. Some large UK banks had too little equity to absorb substantial losses of any description. What the accounts showed in the run-up to the crisis was the rapid increase in banks' total assets – both loans and trading instruments – and the suppression of equity, especially equity measured on a rigorous basis (excluding debt-equity hybrids and goodwill). This was partly a management/governance issue – pursuing ambitious targets for return on equity was one of the motives. It was reckless for boards to allow businesses that are not only cyclical but prone to unexpected losses to have so little equity available to absorb losses. It was also a regulatory and supervisory issue, hence the tightening of capital and liquidity requirements since the crisis, and much more intensive supervision.

13. Accounting standards are being blamed for a lack of loan loss provisions, although the underlying issues were a lack of retained profits to bolster equity, poor lending decisions and weak regulatory oversight. The most important reforms in the wake of this are to capital requirements, resolution regimes and bank structure, including specific reforms in the UK that also improve regulatory architecture. Many people believe that an expected loss model will create a useful step towards holding sufficient reserves in readiness for a downswing. It would prevent banks appearing as profitable in the upswing and as loss-making in the downswing as they did under an incurred loss model. But such smoothing can be abused – used to manipulate earnings and mask the underlying economic reality. The reality is that banks' profits are cyclical and balance sheets must be strong enough to withstand expected and unexpected losses.

14. Other factors contributing to the crisis included artificially high credit ratings for asset-backed securities and the lowering of lending standards. The former could have a distorting effect on any valuation model, whether it be seeking "fair value" or testing for impairment. Changes in lending standards cannot be captured directly in the accounts, but clues are available in the squeeze on net interest margins and the rapid growth in assets. This reflected a drive for market share with too little focus on the quality of assets. Other evidence, such as the relaxation of loan-to-value ratios, should also have prompted questions about asset quality.

15. Low provisions for bad loans provided evidence of a high point in the credit cycle. A wise board would have retained more profits ready for the downturn – and for any unexpected shock, but the prevailing political message was that boom and bust had been abolished. Instead of retaining a larger proportion of earnings in the upturn, as most sectors do (see the way dividend cover rises in an upswing and falls in a downswing), banks over-distributed to staff via bonuses and to shareholders via dividend increases and share buybacks.

16. One area where the accounts could have helped was in making a clearer distinction between realised gains and mark-to-market gains. It was particularly regrettable that large cash bonuses were paid partly on the basis of "paper" gains in the value of held assets. (This has been tackled in regulatory reforms to pay schemes.) Balance sheets did, however, show the build-up of assets being held and any fair value gains on these had obviously not been "realised".

17. In other sectors, the cash-flow statement is more helpful in telling users of accounts about the conversion of operating profits to operating cash flow. What we could see with banks, however, was the increasing thirst for funding and the reliance of institutions such as Northern Rock on short-term funding from wholesale markets. This was a sign of heavy cash consumption, but that is what one would expect from rapidly growing businesses – and they were praised for their growth at the time. Many users of accounts shared in the pre-crisis failure to predict a freezing of wholesale funding markets. But the accounts did show how vulnerable certain institutions would be if that happened.

18. Fair value accounting will obviously reflect the rise and fall of market prices over a cycle. Many users of accounts know from experience that market prices overshoot in an upturn and undershoot in a downturn. Not all markets go up and down together, so in theory volatility can be mitigated by diversification – but correlation has also proved difficult to predict. Sufficient equity needs to be available to absorb unexpected falls in value and adverse changes in correlation. This can take the form of counter-cyclical buffers of the type now being implemented. Another solution, used by the FSA in 2002-03 for insurance companies, is for the regulator to take a view that prices have undershot and to waive minimum capital requirements if there is evidence that forced selling is adding to the downward spiral.

19. In the run-up to the crisis, fair value accounting was in need of reform to improve consistency of measurement and disclosure of assumptions. That was already in train at both the IASB and the FASB, whose joint work was encouraged by the G20/Financial Stability Board. Improving fair value measurement was particularly important for assets in illiquid markets. The three-level method of measurement, covering the switch from mark-to-market to mark-to-model, has now been adopted.

20. All fair value accounting does is to give a current market value on the balance sheet date, using the best available information and the most appropriate methodology. In an illiquid market, those methods are similar to the ones that would be used for a fundamental valuation – discounted cash flows, for instance. It is up to users of accounts to decide whether the market price is sustainable and whether the assumptions fed into pricing models are robust. They must constantly be aware that a "snapshot" valuation is liable to change. In 2010, Laux and Leuz published an empirical analysis of the 2008 financial crisis and showed that fair value accounting did not contribute to its severity.

21. A "true and fair view" represents an unbiased view of a company's performance during the period covered by the accounts, and of the value of its assets and liabilities on the balance sheet date. It means that the accounts should represent underlying economic reality, which includes upswings and downswings. Accounting standards help users see this "true and fair" view of reality when management would prefer us to see a rosier version. For instance, the reconciliation of management's "adjusted" profit to those reported under IFRS is always informative. The users we represent do not want accounting to be biased in either direction – towards optimism or pessimism. The FRC gained an opinion from Martin Moore QC in 2008 confirming that "the true and fair concept remains paramount in the presentation of UK company financial statements" post the introduction of IFRS, and that "fair presentation under IFRS is equivalent to a true and fair view".

22. We would like to think that the auditors impose discipline on managements to produce unbiased, "true and fair" accounts. Those of us who are concerned about an inherent conflict of interest in the client-auditor relationship will discount for that and check corporate governance arrangements.

11. What are your views on the current incurred-loss impairment model and its role in the banking crisis? Do you consider that proposals to move to an expected-loss model will address criticisms of the current accounting rules?

23. The incurred loss model would have worked if managements had made sound business decisions, and the boards and prudential regulators who were supposed to keep them in check had "leant against the wind". This would have required more profits to be retained to build up equity ready for the inevitable downturn. In the absence of sensible equity build-up in the good times, a move to an expected loss model may help by prescribing earlier provisioning for losses. But it will not eliminate pro-cyclicality because expectations are more optimistic in upswings. It may also mean that trading losses coincide with an increase in expected loan losses, removing the phasing effect of delaying recognition until losses have been incurred.

24. EL is also limited in that it involves forecasting, which may not be reliable, and takes no account of the unexpected. So there will still be a need to build up additional equity in the good times. It is the role of prudential regulators to ensure that banks do this. They are addressing this through Basel III and additional national requirements, notably in Switzerland, the UK and the US. Recovery and resolution plans will also help, but again this is a prudential not an accounting issue.

12. What is the best method of accounting for profits and losses in trading instruments? Are there any alternatives to mark-to-market or mark-to-model that might better represent a 'true and fair view'?

25. Trading instruments should be presented at their current value. Ideally this is their market value in a liquid market: level one in the measurement hierarchy. If this is not the case, the other two levels are designed to make the best use of market-based information and the characteristics of the instrument. Transparency over the assumptions going into the models is essential. Most banks now give considerable information on this. Valuations on any given date clearly have their limitations, and so gains or losses based on changes between these dates need to be viewed with caution. The numbers are the starting point: judgment is required of bank boards, shareholders and regulators as to whether the current value will rise or fall in the future, and over whether these "trading" assets will ever be sold.

13. Did IFRS accounting standards contribute to a box-ticking culture to the exclusion of promoting transparency and a 'true and fair view' of the business?

26. No. The build-up of both loans and trading assets was clear to see, and so was the suppression of equity as banks narrowly targeted RoE. Boards, regulators and investors who did not respond to the warning signs are responsible for their own action, or inaction.

14. Do we need a special accounting regime for banks? If so, what should it look like?

27. No. Accounting standards for financial instruments will be more heavily used by financial institutions, but it is better that the rules apply to the instruments, or the business functions, than to specific sectors. Otherwise there is a danger of encouraging regulatory arbitrage, allowing the evasion of prudential rules. There room for improvement in accounting for financial instruments. Disallowing the booking of gains on banks' own deteriorating credit is one example (at least this is now clearly disclosed). Another would be the provision of a better split in the income statement between mark-to-market gains and gains resulting from sales.

28. A separate regime is likely to make it even more difficult for investors to understand banks' accounts, especially for generalists, and therefore could result in starving the sector further of capital. It could also lead to other sectors calling for their own regimes, making it more difficult for users of accounts to allocate capital between sectors efficiently.

15. Are there any interim measures (such as mandatory disclosure) which could be introduced in the meantime?

29. There already are. Banks are providing large amounts of information. More is emanating from regulators – stress test results, for instance. Best practice in financial reporting by banks should be identified and urged on the rest. The FRC has set up a Financial Reporting Lab for this purpose and the Financial Stability Board has an Enhanced Disclosure Task Force.

30. The answer should not be more disclosures, but more appropriate disclosures that help the user to see the inherent risks within a bank. The focus should be on the liquidity, interest rate, credit and other market and operational risks that the bank faces. There should be more emphasis on valuation methodologies, casting more light on the profits that a bank takes and how and when it takes them.

31. Overall, banks are being generous with the quantity of disclosure they are giving. Those that are perceived to be aggressive with their accounting practices are being penalised by investors. Further interim measures are not desirable beyond the work that is already being done by regulators on consistent implementation. The sector and its stakeholders would benefit from a period of stability on the accounting side until a better consideration of all further options has taken place.

16. What are your views on current proposals for improving disclosure and dialogue (with particular reference to discussion papers issued by FSA/FRC)?

32. We will be responding to the FRC's discussion paper. We also find helpful the publication by the Financial Stability Board of a report, entitled "Enhancing the Risk Disclosures of Banks" (29 October 2012).

33. Concerning dialogue, we want all regulation to be properly enforced. To do this the regulator needs access to information that goes beyond the public accounts. It must also stress-test valuations and hold meetings with auditing firms to discuss valuation methodology and consistent application. Users of accounts would like to see as much of the information acquired by regulators as possible, but accept that sometimes this would either inhibit the exchanges or risk causing a market reaction that might destabilise the sector. Fear of this may be overdone, however. If something is well explained it should not cause panic, and rumours are often more damaging than fact.

17. Is there a problem arising from the difficulty of qualifying the accounts of a bank? Should auditors be able to 'grade' accounts – from AAA down? What would be the effect of this?

34. The difficulty is inevitable because banks rely on credit. Inquiries such as that by Lord Sharman to clarify the meaning of "going concern" have tackled this issue. Prudential regulators have ordered banks to have recovery plans (going concern basis) and resolution plans (gone concern). These and all the measures designed to make banks more resilient are the most important element of the response.

35. On auditors, apart from applying more independent judgment and consistent methods, they should make more use of matters of emphasis in the audit report. Their report could also include a discussion of the most difficult judgments. Such qualitative commentary would be more useful than a hard and fast "grade", which would be subject to many inhibiting factors. Commentary on important judgments is beginning to appear in audit committee reports, but it would be good to have the auditors' explicit view on this (implicitly it must agree with what the committee says).

36. Shareholders should use AGMs to question the lead audit partner, who is obliged to be present.

18. Should the scope of audit be widened so that auditors can better express a broader view of the business? For example should auditors comment specifically on issues such as remuneration policy, valuation models or risk?

37. Valuation models and risk should be part of the audit committee report but not remuneration policy, which is the job of the remuneration committee. The business review and the audit and other committee reports are the main vehicles for communicating with investors, but there is scope for more meaningful reports from the auditor (see par 35). Users of accounts have to discount for the fact that the auditor is hired by the company. If investors want a separate report from the auditor, they should hire the auditor themselves, which would arguably be a better model.

19. What would be the effect of using return on assets as a performance measure in banks, as opposed to return on equity?

38. We do not believe that a single measure should ever be accorded primary status. RoA can also be manipulated by taking on riskier lending. Both metrics were easy to see in the run-up to the crisis. There are definitional issues over "total" assets, although the number is obviously simpler than one arrived at by risk-weighting.

“Returns” always have to be carefully examined for quality and sustainability. The lengthy notes in banks’ financial statements help users to make a set of assessments of performance and financial state. The issue is how well we and other consumers of financial information use all this information.

20. Are the amendments to the Financial Services and Markets Act 2000 regarding dialogue between regulator and auditor sufficient, or does further work need to be done in this area?

39. This was an essential restoration of a neglected practice. Voluntary activity could build on this, for example dialogue between auditors and shareholders who have signed up to the stewardship code. Client confidentiality and insider trading rules mean that discussions could not be focused on individual companies but would have to be thematic.

We look forward to discussing the issues raised in this response.

Yours sincerely,

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Chair, Financial Reporting and Analysis Committee
CFA Society of the UK

Will Goodhart,
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CFA Society of the UK

About CFA UK and CFA Institute

The CFA Society of the UK (CFA UK) represents the interests of more than 10,000 leading members of the UK investment profession. The society, which was founded in 1955, is one of the largest member societies of CFA Institute and is committed to leading the development of the investment profession through the promotion of the highest ethical standards and through the provision of continuing education, advocacy, information and career support on behalf of its members. Most CFA UK members have earned the Chartered Financial Analyst® (CFA®) designation, or are candidates registered in CFA Institute’s CFA Program. Both members and

candidates attest to adhere to CFA Institute's Code of Ethics and Standards of Professional Conduct.

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