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AUDIT INSIGHTS
BANKING

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The series was initiated by ICAEW's Audit and Assurance Faculty (AAF). This report forms part of this series and has been led by ICAEW's Financial Services Faculty (FSF) working with AAF. It complements FSF's own *Inspiring Confidence in Financial Services* initiative.

For more information about the Audit Insights series, visit icaew.com/auditinsights.
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ABOUT THE ICAEW FINANCIAL SERVICES FACULTY

The ICAEW Financial Services Faculty was launched at the start of 2007 to provide professional support to ICAEW's members working across the financial services sector, to influence public debates on regulation and standards affecting the sector and to become a world-class centre for thought leadership. The *Inspiring Confidence in Financial Services* initiative was established in early 2007, shortly before the start of the global financial crisis. It aimed to provoke new thinking and identify better ways of tackling long-term challenges in the financial services sector.

Confidence is vital to financial services. A stable financial system is important to the economy and sustainable levels of confidence in financial services are needed for this stability. Our work is based upon four themes, which are interdependent and cannot be considered in isolation. These themes are:

- Responsible providers
- Responsible consumers
- Better information
- Better regulation.

Our work involves developing reports and provocative issues papers, holding high-profile conferences and having discussions with stakeholders. We aim to bring together the financial services sector, industry professionals, consumers, regulators and policy-makers. We believe that financial services will only inspire confidence if the sector engages with all of its stakeholders.

For more information about the *Inspiring Confidence in Financial Services* initiative, visit icaew.com/inspiringconfidence. For more information about the Financial Services Faculty visit icaew.com/fsf. Alternatively contact Iain Coke at iain.coke@icaew.com

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AUDIT INSIGHTS
BANKING

FOREWORD

Audit Insights: Banking is the third in ICAEW's *Audit Insights* series and follows reports on retail and manufacturing. It is based on the collective insights of banking audit specialists from BDO, Deloitte, EY, Grant Thornton, KPMG, Mazars, the National Audit Office and PwC.

The *Audit Insights* series is one of a number of initiatives undertaken by ICAEW in response to the global financial crisis. These include the 2010 report *Audit of banks: lessons from the crisis*, our 2011 report *Reporting business risk: meeting expectations*, the 2012 good practice guidance *Enhancing the dialogue between bank auditors and audit committees*, and our 2013 paper *Principles for good financial regulators*. The challenge of instilling integrity into business models is addressed in the 2012 research paper *Real integrity*, while our 2012 report *Market failures, market solutions* makes proposals for restoring trust in financial institutions. ICAEW has also contributed to public debates on important financial reporting issues such as how to improve loan loss provisioning. This report complements all this work by drawing public attention to important business issues in banking.

Banking has been under intense scrutiny since the start of the credit crunch in 2007 and through the global financial crisis that ensued. As a result, banks have made changes to their businesses, improved the information they publish and strengthened governance and internal control. There have also been major reforms to how banks are regulated. All this has made banks safer but has also added to their costs of doing business. Banks are now targeting lower returns to investors and reforms will also affect bank customers who may need to pay more for a narrower range of banking products and services.

Our report highlights four long-term business challenges that banks still face in relation to: cultural change; the potential need to rethink their business models; challenges in measures used to assess their financial strength and performance; and demands for major IT investment. Responsibility rests primarily with bank boards and there are no quick or easy fixes.

EXECUTIVE SUMMARY: FOUR FLAGS FOR THE BANKING SECTOR

FLAG 1: BANKS SHOULD KEEP WORKING TO RESTORE TRUST

Restoring trust is arguably the biggest challenge facing banks and their boards. This requires cultural and behavioural change. While banks are seeking to address this challenge, they will need to examine how their business operations support efforts to increase levels of professionalism and integrity in banking.

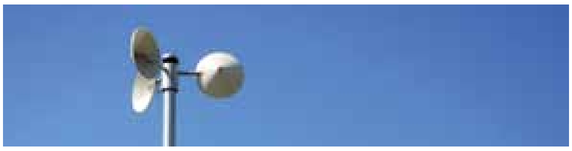
Banks have to rethink how they recruit, train, manage, motivate and incentivise all their people. Boards have an important role to play in this and must not only set the right tone from the top, but consider how all of their other decisions support creating a healthy culture based on the stated values of the organisation however great the conflicting challenges.

FLAG 2: BANKS SHOULD ADAPT THEIR BUSINESS MODELS TO THE NEW WORLD

Banks need to adapt their business models from a pre-crisis world of prolonged revenue growth and plentiful capital to be suitable for the post-crisis environment where capital requirements are higher, revenues are constrained and regulation is stricter, more intrusive and more costly.

In the absence of reliable revenue growth, banks are striving to reduce their costs despite pressures pushing the other way, including those related to increasing costs of redress and associated regulatory penalties. Regulators are concerned over business models that rely on cross-selling or cross-subsidisation.

These factors point towards the need for banks to rethink their business model. Boards will need to consider more closely the costs, revenues and profitability of individual product lines, the amount of capital needed to support them and the regulatory expectations of the nature of products and services offered to customers and how they are offered to them.



FLAG 3: BANK PERFORMANCE REPORTING COULD BE IMPROVED

Banks produce a variety of different industry-specific performance indicators against which their performance and position is measured. Many of these are neither prepared using industry-standard methodologies nor based on generally accepted accounting principles nor are they audited. Consequently they may not be directly comparable across different banks.

The lack of easy comparability of such performance measures and other disclosures is a source of frustration for users of banks' reports. The banking industry needs to collectively drive forward improving the consistency and comparability of their public reporting.

A number of risk measures, including regulatory capital ratios, are calculated by large banks using the bank's own internal models. These internal models fall outside the scope of external auditors' work and generally differ from the models used to establish balance sheet values. The outputs from these risk models can vary widely between banks and the reasons for these variations can be opaque to external stakeholders.

Bank boards need to ensure there is good governance and control over their bank's internal models, including the principles that underpin them. They should also consider whether they are provided with sufficient assurance that the inputs and assumptions applied to the models are reasonable.

EXECUTIVE SUMMARY: FOUR FLAGS FOR THE BANKING SECTOR

FLAG 4: BANKS NEED MAJOR IT INVESTMENT TO DEAL WITH GROWING RISKS

In the future, banks are likely to engage with their customers very differently from how they have in the past, with more customer demand for digital and mobile solutions. Continued investment in technology will be needed for banks to meet the needs of the next generation of bank customers who have grown up online.

Banks face increasing threats from cyber-crime and other system vulnerabilities. Banks' IT infrastructures are complex and many banks' core IT systems are old and are patched together as a result of acquisitions and a lack of investment. Interfaces between systems are not only expensive to maintain but also create a higher risk of system failure. Major investment is needed in core systems.

Bank boards need to improve their expertise in this area to enable them to properly assess their IT infrastructure, the risks their bank faces and the investments that are necessary. In making those investment decisions, boards will need to find the appropriate balance between shorter-term profitability and longer-term security and resilience.

INTRODUCTION

The global financial crisis has forced policy-makers to rethink how bank regulation is organised, regulators to rethink rules on bank safety and banks to rethink how they do business.

BANKING HAS UNIQUE RISKS

Perhaps the most distinctive feature of banking is the vital role that banks play in the money supply of an economy by intermediating between those who have funds to save or invest and individuals, businesses and governments who need finance. Although banks are commercial businesses, this essential role means that there is a clear public interest in having a stable banking system.

To avoid a bigger cost in terms of jobs and tax revenues, there will always be a case for government support in the event of serious failures of banks or banking systems. Since the start of the financial crisis, much government and regulatory effort has been directed at trying to reduce the likelihood and scale of any such future public interventions.

Banking is inherently risky. Many of its inherent risks relate directly to the value provided by banks to their customers and the wider economy. Banks are commercial businesses and seek to make a commercial return through managing these risks.

Banks face credit risk from lending, liquidity risk from accepting short-term deposits and making longer-term loans, market risk from supporting the operation of financial markets, operational risk from facilitating the payments system and conduct risk in their interactions with customers. Banks also create financial stability risks due to their role in supplying credit to the wider economy and transmitting government economic policy. These risks never change very much. Box 1 provides a summary.

WHAT WENT WRONG?

A broad consensus has emerged about the major factors that led to the global financial crisis and these are summarised below.

Aggressive pursuit of revenue. An emphasis on shareholder value and a belief that risk could be measured and managed more effectively than in the past led to too much emphasis on growing banking businesses to provide higher rewards to shareholders, senior management and employees who were major risk takers and revenue generators.

BOX 1: UNDERSTANDING BANK RISKS

RISKS TO BANKS

Credit risk. This is created by bank lending and is the risk that bank loans won't be repaid in full.

Liquidity risk. This is created by banks funding long-term loans through shorter-term deposits, an important economic function known as maturity transformation. It is the risk that a bank will not have enough cash on hand if a significant proportion of its customers withdraw their deposits at the same time.

Market risk. This is created by banks supporting financial markets by holding assets and liabilities and offering products linked to market rates. It is the risk that a bank will be adversely affected by changes in market prices.

Operational risk. This is a collection of risks facing banks and relates to the possibility of some operational failure adversely affecting the business. Many of a bank's operational risks, such as systems failure or loss of key staff, are common to all businesses but such failures in a bank can have wider systemic effects.

Conduct risk. This is a particular form of operational risk created by banks providing advice and designing and offering new products and services for customers. It is the risk that a customer is disadvantaged through the fault of the bank, as a result of which the bank will typically suffer reputational damage and regulatory penalties and will need to compensate the affected customers.

RISKS TO THE BANKING SYSTEM

Financial stability risk. Banks stimulate the wider economy by controlling the flow of finance and transmitting government and central bank policies into national economies. Over the past two decades, central banks have primarily used the money supply and interest rates to control inflation and economic growth. Problems in the banking system can cause wider instability in the economy.

Procyclicality risk. Banks, like all businesses, are affected by the business cycle but the unique position of banks means they reinforce and exaggerate the effects of the business cycle, creating a particular risk to financial stability.

Moral hazard risk. Banks have such an important role in the functioning of economies that the consequences of banking system failure can be so severe that governments may be forced to bail-out banks. This creates the 'moral hazard' that banks behave with less risk awareness due to an implicit government guarantee.

Information asymmetry risk. Banks will nearly always have a better understanding of their products and services than their customers. This makes customers particularly vulnerable to mis-selling.

INTRODUCTION CONTINUED

Lehman Brothers for example ultimately suffered from its deliberate decision to pursue a high-growth strategy, moving away from traditional investment banking business to a model that involved retaining assets and risks rather than selling them on markets.

Excessive leverage. Banks were able to obtain significant amounts of cheap debt finance and use this to generate higher revenues and higher returns on equity through gearing while making comparatively cheap lending available to customers. However, it left the banking system more vulnerable to the effect of losses. This is best exemplified by investment bank Bear Stearns, which was renowned for its risk-taking strategy. It was one of the most highly leveraged institutions, with US$11.1bn of equity supporting a balance sheet of US$395bn by the end of 2007.

Insufficient capital. Banks were allowed to operate with too thin buffers of capital for the risks they were taking. Banks were only required to hold pure equity capital of 2% of the risk-weighted value of their assets.

Over-reliance on short-term funding. Banks relied too heavily on their ability to obtain funds with short maturities from the interbank market and other short-term money markets. Some banks used this cheap short-term funding to finance long-term assets repeatedly renewing this short-term funding over the life of the related assets. It seemed unthinkable that banks would stop lending to each other, but Northern Rock illustrates the problems that arose when banks did this. It struggled to renew its short-term funding when it had to refinance expiring deals and as news of this emerged, it faced queues of depositors seeking to withdraw their funds.

Financial innovation. Driven by the rise of financial mathematics, innovation took place on an unprecedented scale. While many innovations, such as the use of securitisations to facilitate funding and spread risk, had real benefits they were often taken too far. The result was increased complexity and opacity. It was generally believed that derivatives and securitisations dispersed risk outside the banking system, which helped to fuel the growth in lending at quality and prices that would not previously been seen as acceptable. The crisis showed that risk was much less dispersed than had been believed.

Mis-pricing of risk. A long period of relatively buoyant economic conditions together with financial innovation, led many to believe that risk had been permanently reduced or transferred. Banks progressively reduced their charge for bearing credit risk, so that their interest margins were low and – together with low capital buffers – provided insufficient protection against losses. These conditions encouraged banks to create new products that gave higher returns while still being considered low risk, such as derivatives that packaged sub-prime mortgages. With hindsight, this was mistaken.

Lack of diversification in some banks' business models. Some banks specialised in particular types of business activity. This concentration left them particularly exposed to any problems in those activities. For example, Bradford and Bingley in the UK concentrated on providing self-certified and buy-to-let mortgages. The bank's part nationalisation resulted from problems in those markets.

Macro-economic policies. The factors outlined above were facilitated by the ready availability of liquidity in global markets. This stemmed in part from monetary policy which, with hindsight, appears to have been too loose in many countries. Huge flows of capital within the global economy were also important. They arose from balance of payments imbalances, notably Asian surpluses matched by an American deficit.

Insufficient attention to financial stability. While central banks monitored financial stability risks, they had neither sufficient tools nor adequate coordination to take action against emerging risks to the global financial system. There was too much reliance on the markets to self-correct. In the UK, the powers for regulating financial stability were split between HM Treasury, the Financial Services Authority and the Bank of England, a division which has subsequently been changed.

WHAT HAS CHANGED?

Globally, banking regulation has become tougher and national regulations have been tightened, sometimes going beyond internationally agreed standards. New regulations require banks to hold more capital as a buffer against future losses and larger stocks of liquid assets as a protection against the inherent mismatch of holding short-term liabilities and long-term assets. New rules have been introduced to oblige banks to organise themselves so that it is easier for them to recover from problems or, if this is not possible, for regulators to wind down failed banks in a more orderly fashion.

Bank boards have also been working to comply with new regulations, reduce the risks to their businesses and instil greater market confidence in their bank's stability. However, national differences in changes to banking regulation are making it more difficult for international banks to implement regulatory changes.

Banks have typically reduced their balance sheets so that they hold more liquid assets, less risky asset portfolios, lower leverage and bigger capital buffers. The balance sheet of the Bank of England shows that commercial banks' collective deposits repayable on demand at the Bank had increased from £18bn in February 2007 to £295bn by February 2013. This shows the mechanics of the Bank of England's quantitative easing programme. For commercial banks, higher deposits at the Bank of England are part of their higher stock of liquid assets and provide greater protection against liquidity risks. However, banks generally try not to hold large balances at the central bank due to the very low interest that they receive on those deposits.

Changes to bank balance sheets reflect the combined effects of banks themselves learning lessons from the financial crisis, the impact of regulation and the impact of the crisis on bank customers. These factors have made banks more risk averse and increased the costs of running a bank.

Bank customers are now more risk averse. Individuals and corporates have deferred spending on longer-term projects and, to the extent they can, have been hoarding cash. This is particularly true for large corporate customers. This contrasts with the position of many SME businesses which are more reliant on bank finance. Banks now have tougher lending criteria than in the run-up to the financial crisis.

Despite changes to make banks safer, the task of rebuilding bank balance sheets is not yet complete. Some issues will take more time to address fully, including legacy assets from pre-crisis lending, over-leverage among some customers and the potential impacts of further Eurozone or sovereign debt problems. The restoration of economic growth will ease some of these issues but, if interest rates were to rise significantly, this could cause difficulties for bank customers that could cause further losses for banks.

FLAG 1: BANKS SHOULD KEEP WORKING TO RESTORE TRUST

The biggest business challenge currently facing banks is how to restore trust. This challenge is being taken very seriously by bank boards and the new generation of bank chief executives.

Any bank's biggest asset is the trust of its customers. Being seen to behave fairly and with integrity is critical to building and maintaining trust and fostering long-term customer relationships. However, repairing the sector's reputation is not an easy or quick issue to fix and the restoration of professional standards in banking is in its infancy.

The importance of restoring trust is reflected in some ICAEW initiatives summarised in Box 2.

BOX 2: ADDRESSING THE CHALLENGE OF RESTORING TRUST

The ICAEW Financial Services Faculty's report *Market failures, market solutions*, published in November 2012, challenged the financial services sector to take stronger action to restore trust. It stressed the importance of industry-led initiatives in building trust, and argued that leaving this to regulation risks reinforcing a perception that financial institutions are incapable of acting responsibly.

The report recommended a number of practical steps that institutions can take to regain public trust. These include seeking to establish a professional approach, rethinking how business models address integrity, raising professional education requirements and making their products and services more understandable.

The Financial Services Faculty has also developed guidance in line with international standards to provide assurance on financial and commodity benchmarks following the LIBOR scandal.

ICAEW's *Valuing Integrity Programme* has been designed to assist banks in implementing values-based cultural change, identifying practical challenges in implementing such change and understanding better how to balance competing objectives that might otherwise create conflicts of interest.

THE CHALLENGE OF CULTURAL CHANGE

Bankers recognise the need to change culture and business practices both at their own firms and across the sector. However, academic research shows that people typically have a tendency to overrate their own integrity and believe that the larger problem lies with others. Research in this area of human behaviour has been supported by the *Real Integrity* research funded by ICAEW's charitable trusts and by a number of separate pieces of research into the banking sector undertaken by major accountancy firms.

Bank boards and senior management need to demonstrate the correct tone from the top, not only through public statements, but by being seen within their organisation to be following the new values they promote publicly. They need ways to measure the success of cultural change programmes and internal audit functions may have a role in assessing this. Internal audit and independent risk functions may need to be given greater status within banks and broader remits so that they are better able to challenge risk takers. Implementing cultural change on the scale needed at present is a difficult task and will inevitably take time.

BALANCING DUTIES TO INVESTORS WITH RESPONSIBILITIES TO CUSTOMERS

Banks are commercial businesses. Boards have legal duties to act in the interests of their investors. Over the long term, there are sound business reasons for any business to treat its customers well as no business is sustainable without the goodwill of its customers. However, there can be conflict in the short term between the interests of investors and customers.

The nature of banking and the asymmetry between the financial knowledge of banks and their customers, particularly retail customers, means that customers need to rely heavily on the advice of banks. In addition to legal duties to investors, UK banks and their boards are also required by regulations to treat their customers fairly.

Getting the balance right between the duties to investors and the responsibilities to customers will always be difficult and banks are still working through this and the implications for the products they offer, whether by changing business culture or changing incentive structures.

INCENTIVISING PERFORMANCE

Of all board decisions, those of the Remuneration Committee receive the most public attention. The first thing that many people look at in any set of published accounts is the remuneration disclosure. High pay and bonuses have been seen as responsible for conflicts of interest, excessive risk taking and ethical lapses. The full situation may be more complicated.

Remuneration policies have often created a bias in incentives to maximise short-term revenues. Banks have historically used financial incentives to a significant extent to drive business performance. Investment banks also compete against each other to attract star performers who can generate high profits. This has driven up historical levels of remuneration and while individual banks recognise this problem, they run the risk of losing their best staff if they take unilateral action to address it.

Factors other than high pay can also have unintended consequences that create conflicts of interest. These include recruitment policies, the way that people are trained and managed, performance targets and a banks' broader culture. How people gain status within an organisation and how they are evaluated and promoted also drives behaviour. For most people, the level of pay received at the top end of banking should mean that incremental amounts of money should become less effective as motivation but for a highly competitive person, the annual bonus, and how it compares against those of their peers, can be seen as the clearest measure of success.

REGULATORY PENALTIES FOR MISCONDUCT

Managing conduct risk, and the consequential reputational damage and costs if it is not well-managed, is increasingly difficult for banks. The immediate financial costs of this risk can be split between potential compensation payments to customers and regulatory fines, both of which have increased significantly. Looking to the future, the continuing costs of compliance will be higher than before.

Quantifying the costs of dealing with historical problems is challenging. It can take time for problems to be identified and the amount of customer compensation payments depends on the number of complaints received. Once a problem has been identified, as part of the 'treating customers fairly' rules banks are required to identify all those customers it believes may have suffered as a result and notify them of their rights, and also consider complaints from any other customers who feel they may have suffered loss. The level of these complaints received can be unpredictable, and can be affected by the publicity an issue has received and the activities of claim management companies.

Taking the mis-selling of payment protection insurance as an example, many banks have found that a significant number of the complaints they have received have been from people who never had PPI policies with them or who had made successful claims against their policies. Processing such invalid complaints has added significantly to the cost of addressing misconduct issues.

LESSONS FROM LIBOR

The scandal over LIBOR and other interest rate benchmarks has had one of the most damaging effects on trust in banking. This is because it involved attempts to manipulate interest rates, benchmarks that underpin much banking activity. The LIBOR scandal involved two distinct problems. The first was that some banks' senior management sought to adjust LIBOR submissions to signal their own financial strength at the height of the financial crisis by lowering their estimates of their cost of borrowing. The second was that traders at some banks sought to manipulate interest rates to benefit their own trading positions. Both are serious issues.

The motive for the first issue appears to have been survival at a time when markets were actively looking for the next bank likely to fail. This does not however excuse a lack of ethical behaviour.

The cause of the second issue was the aggressive pursuit of profit motivated by personal ambition. Evidence published by regulators suggests that some traders sought to influence market rates in order to further their individual standing and personal bonuses. Some of the people involved in making LIBOR submissions or acting as interbank dealers were influenced by pressure from those traders. This resulted in people behaving in ways that not only bent or broke normal standards of ethics but may also have been criminal. Bank boards

FLAG 1: BANKS SHOULD KEEP WORKING TO RESTORE TRUST CONTINUED

and senior management take such lapses seriously and such breaches usually result in dismissal. However, the fact that this happened indicates the existence, at some levels in some banks, of a culture in which it was acceptable to bend the rules to meet targets.

The LIBOR scandal highlighted weaknesses in controls and governance over LIBOR submission processes. Banks have extensive controls and monitoring over trading activities but insufficient attention was paid to processes that were mainly seen as administrative and that did not directly create risks to banks' balance sheets or profitability. In response to the LIBOR scandal, regulators are reforming LIBOR and requiring banks to strengthen their controls and governance in this area. This has included requiring banks to have the controls over these processes subject to assurance from internal and external auditors.

Regulators have also become concerned that bank and other traders may have sought to distort other important markets in similar ways, including energy and foreign exchange markets. Banks and other trading businesses need to look more broadly at their control and governance systems to ensure that they consider not only direct market risks but also the risk of potential forms of market manipulation. Banks' risk management and internal audit functions need to consider these types of risks more explicitly. Back office functions need to be given appropriate status to allow them to challenge and withstand pressure from traders and revenue generators.

Recommendations

- Bank boards need not only to set the right tone from the top but also to rethink how their bank recruits, trains, manages and motivates people and consider whether their decisions support a culture based on the stated values of the organisation, not just its profit targets. This requires banks to move beyond statements of intent to considering the deeper challenges of long-term implementation of cultural and behavioural change and measurement of change when it happens.
- Banks' risk management, internal audit and back office functions need to be given broader remits and greater status within the organisation to allow them to challenge revenue generators more effectively. Control and governance systems may need to be extended to consider a wider range of potential forms of market manipulation.

FLAG 2: BANKS SHOULD ADAPT THEIR BUSINESS MODELS TO THE NEW WORLD

Banks need to adapt their business models from a pre-crisis world of prolonged revenue growth and plentiful capital to be suitable for the post-crisis environment when they are required to hold more capital, and experience more constrained revenues, increased cost pressures and tighter regulation.

Banks need to look more closely at the interaction between revenues and costs, better understand the profitability of their products and services and how they utilise their available capital. This may in turn require banks to rethink their business models, how they allocate costs and revenues and how they charge for different products and services.

MANAGING COSTS AND REVENUES

Banks typically manage their products and services on a portfolio basis. This is in part because banks have high overhead costs and allocating those costs to particular product or service lines can be judgemental and, if done at all, is often not precise. Overheads include the costs of employing staff, maintaining complex IT systems, meeting regulatory capital and liquidity requirements and, for high street banks, running a branch network.

The way that banks currently look at costs and revenues means that, while they closely monitor the profitability and performance of portfolios of products and services, they are not always able to accurately assess the profitability of individual product or service lines. Now that capital is an important constraint for banks, they need to better understand the profitability of individual lines of business and how much capital is required to support them.

INCREASING COSTS OF REGULATION

Banks face increasingly tough regulation. As products evolve and problems emerge, new regulations are brought in as a result. However, it is more difficult to remove existing regulations for fear of a repeat of past problems. Banks are now more risk averse in relation to potential regulatory penalties. It is notoriously difficult to assess the costs and benefits of regulation. The cost-benefit analysis used by regulators requires significant judgement. It can be hard to accurately identify the truly incremental costs of regulation and the biggest benefits can be the unknowable problems avoided.

BOX 3:
THE UK ‘FREE’ BANKING MODEL

In the UK, personal bank accounts are generally offered free of charge, in that people do not typically pay a fee for opening an account, keeping one open or putting basic transactions through the account as long as they are in credit or do not exceed agreed overdraft limits. The UK is unusual in having this free banking model. It is relatively new even to the UK, as it only first became common in the early 1980s when competition drove all the mainstream banks to adopt it. It also only applies to personal banking in the UK, with business accounts being subject to charges.

Banks generally estimate the costs of providing a free bank account at around £75–£100 a year per account. The majority of these costs are a share of the high overhead costs of running branch networks, staff, IT systems and regulatory compliance. The processes themselves involved in running these accounts are highly automated so that the direct costs per bank account are much smaller.

Banks need to cover their overheads and earn money in various ways to do so. One way is through net interest margin, ie, paying depositors less interest than the bank would need to pay to raise funds elsewhere. If a bank earned a 2.5% margin on customer deposits, a customer would need to keep an average balance of £4,000 to generate annual revenue of £100 to cover costs, let alone generate a profit margin. This is significantly higher than the average balance of most account holders. At the current very low level of interest rates such a margin is hard to generate, even though banks are paying low rates of interest to depositors.

Despite these cost and revenue challenges, banks’ retail businesses still make money in the ‘free’ banking model. Banks do so by charging penalty fees, for example when customers breach overdraft limits and by adding more profitable services for which they are able to charge fees, including selling products that make higher margins, such as cards and mortgages, or where there is less strong competition. However, some UK banks have started to charge for current accounts. It is likely that over time this practice will become considerably more widespread.

FLAG 2: BANKS SHOULD ADAPT THEIR BUSINESS MODELS TO THE NEW WORLD CONTINUED

Notwithstanding the difficulties of assessing costs and benefits, it is clear that the costs of regulation are increasing, in terms of capital and liquidity requirements, conduct of business rules and consumer protection regulation. This has contributed to an increase in borrowing costs for individuals and businesses. It is also probable that the strong regulatory focus on reducing the likelihood of unsuitable products being sold to customers will lead to banks increasingly offering only the most straightforward and low risk products. These may not be sufficient to meet the needs of some households and SMEs.

While there is therefore a strong case for enhanced consumer protection through banking regulation, it is important that a balance is struck between consumers' own responsibilities and conduct regulation designed to protect them. Banks need to rethink business models that rely on cross-subsidisation and create potential conflicts of interest. Consumers must be prepared to accept that it is better to pay directly for the core services they receive rather than implicitly accepting a system of cross-subsidisation with all the consequences that flow from that.

REGULATORY PRESSURE ON CROSS-SUBSIDISATION

Bank management, together with regulators such as the Financial Conduct Authority, are looking more closely at the profitability of individual business lines as potential warning signs for potential misconduct. They are examining lines that do not appear to be individually profitable for the risk that either a bank is not providing a sufficiently high quality service or that the lines create too much pressure to cross-sell other products. The UK 'free' banking model, set out in Box 3, is an example of an individual service line that is not always individually profitable. Regulators are also likely to examine lines that generate high profits for the risk that those products or services do not meet customer needs, with PPI being an example of where this can go wrong, as set out in Box 4.

BOX 4: THE PAYMENT PROTECTION INSURANCE EXPERIENCE

Payment protection insurance (PPI) is a clear example of when cross-subsidisation went wrong. PPI, in principle, could be a suitable insurance product for some customers. However, because consumer credit was so competitive, lending rates were pushed down to levels that made the lending unprofitable unless there were some additional revenues. PPI gave banks such an additional revenue stream that generated very high profit margins. As a result, they incentivised their staff to sell PPI and it was aggressively oversold with insufficient attention paid to whether it was suitable for individual customers.

Including PPI in the standard sales pitch may have made some customers think that it was normal, that they would subject themselves to undue risks by not taking up this option or that rejecting PPI might adversely affect their credit application. In some cases the mis-selling extended to people who were not even eligible for payouts under the policies. Some customers were able to make successful claims against PPI policies, but PPI did generate high profit margins which supported banks' dividends.

There is a suspicion, particularly from regulators and consumer groups, that the need to cross-subsidise core banking services that have not been individually sufficiently profitable may have contributed to previous mis-selling problems in the industry. In any event, it is clear that, in the period leading up to the crisis, there was too much focus on incremental revenue and insufficient focus on 'treating customers fairly'. Integrity and trust were eroded.

While banks have been able to operate with cross-subsidisation and cross-selling models, many senior bankers are keen to move away from this approach but competitive forces make it difficult to change. Despite consumer group concerns, free banking, for example, is still popular among bank customers.

FLAG 2: BANKS SHOULD ADAPT THEIR BUSINESS MODELS TO THE NEW WORLD CONTINUED

Regulators may, however, move to further restrict cross-subsidisation models.

A bank account is an important foundation for ensuring that all members of society are integrated into the mainstream economy. Financial inclusion is an important political issue. For that reason it is probable that some level of very basic low cost or free banking will need to continue to be provided to prevent financial exclusion. It is therefore likely that an element of cross-subsidisation may always be required, but not on the current scale. Looking to the future, a key strategic issue will be how banks define their current account products, and how they will determine who is eligible for a 'free' account and who has to pay. Seeking to differentiate offerings to incentivise the majority to pay will become a key strategic issue.

RETHINKING BANK BUSINESS MODELS

All of the factors highlighted above have put pressure on traditional commercial banking business models. High street banks also face increased pressure from internet-based challenger banks and more innovative forms of finance such as peer-to-peer lending which may be able to run on lower overhead costs as they do not have expensive branch networks.

Banks will need to change how they manage costs and revenues to generate sustainable returns above the cost of capital in the post-crisis environment. This may require changes to current business models. The pressure to reduce costs is intensified and greater automation will be required. As a result, banks may look to charge directly for core products. This may put added pressure on the UK 'free' banking model and may result in banks offering customers fewer and simpler products and services.

Investment banking business models are also under pressure, where the need to adjust for risk in assessing revenues and profitability is at its most acute. Investment banks also face challenges around cultural change and regulatory scrutiny over the potential for conflicts of interest leading to misconduct and increasing pressure from so-called 'shadow banks', which carry out bank-like activities but are not themselves regulated as banks.

Any transition to a new business model carries the risk of control failures and banks will need to consider carefully their control environments both during the transition and for the longer term so that they do not suffer from the unintended consequences of new failures.

Recommendations

- In the post-crisis environment where capital requirements are higher, revenues are constrained and regulation is more costly, banks need to rethink the way that costs and revenues and the associated capital are allocated to individual product and service lines to allow them to understand better the profitability of those lines.
- Bank boards should consider whether business models which rely on cross-selling of additional products and services are sustainable and whether lines which generate very high levels of profit margins meet their obligation to treat customers fairly.

FLAG 3: BANK PERFORMANCE REPORTING COULD BE IMPROVED

Banks produce many performance and regulatory measures that are used for a variety of purposes. Investors and analysts use various measures and disclosures to compare a bank's year-on-year performance and strength, to compare banks with other banks and to compare an investment in a bank with an investment in other sectors. Some of these measures and disclosures are not easily comparable. Regulators also use a variety of measures to supervise the financial strength of a bank. Some of these measures may not be as reliable as they should be. Banks are also facing the challenge in moving to a more complex regime of regulatory measures.

COMPARABILITY OF PERFORMANCE MEASURES AND DISCLOSURES

Investors, analysts, regulators and others looking to assess the performance, financial strength and risks associated with banks use a variety of different measures and disclosures. They are also used to compare different institutions. Banking has perhaps more sector specific measures that are commonly used and seen as critically important. Box 5 sets out some of the more important banking measures.

Many of these key performance measures can be prepared in a variety of different ways. Bank annual reports include a lot of performance indicators that are neither derived from audited numbers nor prepared through standard methodologies.

Principles-based accounting standards allow a degree of judgement in their application and differences in accounting regimes between banks reporting under International Financial Reporting Standards (IFRS) and US accounting rules can significantly affect the metrics. For example, US accounting rules allow more derivatives to be netted off against each other than under IFRS meaning that a bank may appear to have lower leverage under the US rules purely due to accounting differences.

The challenge of comparability of performance measures and disclosures is not always helped by efforts to better explain businesses and the risks facing them. Banks have to disclose a wide range of information in addition to that presented in the financial statements. This includes additional regulatory disclosures required under Basel 2 which are intended to impose market discipline and new voluntary additional disclosures suggested by the Enhanced Disclosure Task Force, which was initiated by the Financial Stability Board but taken forward by a group of banks, investors and auditors working together to develop a market-based solution to the challenge of how banks should explain their risks. While all of the different disclosures are useful in explaining particular risks, taken together the volume of disclosure requirements makes bank annual reports more complex. Banks as a result face a difficult challenge of providing extensive disclosures demanded by different users while making their financial statements accessible to non-specialists. The lack of comparability remains a source of frustration for analysts and investors.

FLAG 3: BANK PERFORMANCE REPORTING COULD BE IMPROVED CONTINUED

BOX 5: MEASURES THAT MATTER

In addition to measures common across all businesses, like profit, revenue growth, return on equity, dividend growth and share price-based measures, banking has its own set of specific performance and regulatory measures. Some of the most important are described below.

- **Capital ratios**: These are a key regulatory measure. They compare 'risk-weighted assets' to the level of capital a bank holds. A higher capital ratio means the bank has more capital to offset against potential losses on its risk-weighted assets. Regulatory minimum equity capital ratios have increased from 2% under Basel 2 to about 10% under the Basel 3 and the EU Capital Requirements Directive IV (CRD IV) reforms triggered by the financial crisis. Some regulators are going further with their local requirements. These reforms have also tightened the definition of what counts as equity capital for regulatory purposes.
- **Risk-weighted assets**: This provides an indication of the risk that a bank is subject to and is a value rather than a ratio. This is measured based on regulatory rules which are very different from how assets are measured on a bank's balance sheet. The more risk a bank is subject to, the higher the risk-weightings. Assets considered risk-free, such as deposits at the Bank of England, have a risk-weighted value of nil. Often complex internal models are used to calculate the risk weightings.
- **Leverage ratios**: These are simpler measures of bank safety than capital ratios. They compare the value of assets to capital and are not adjusted for the riskiness of assets. Before the crisis, international bank capital rules did not include a leverage ratio although some countries such as Canada did use this tool in their national rules. A 3% leverage ratio has been introduced as part of the Basel 3 and CRD IV reforms, meaning that banks must have capital of at least 3% of the value of their assets. Some commentators have called for higher leverage ratios.
- **Liquidity ratios**: These measure the risk to short-term cash flows in view of the fact that banks have short-term liabilities such as customer deposits and long-term assets such as mortgages. There are many ways of measuring liquidity risk, and a multiplicity of liquidity ratios, but they typically compare the stock of assets that can be immediately turned into cash (such as central bank deposits) to anticipated cash outflows. As with the leverage ratio, international capital rules did not include minimum liquidity requirements before the crisis but they have been introduced through Basel 3 and CRD IV.
- **Value at risk (VaR)**: This was used as a key management tool in the run-up to the crisis and also fed into banks' internal models used to measure the risk-weighted assets in their trading books. It attempted to put a value on how much a bank might stand to lose from trading positions on a bad trading day. For various reasons, these models may have contributed to banks underestimating or missing some risks. Over-reliance on VaR without sufficient understanding of the limitations in the models may have contributed to the build-up of significant risks in the banking system.

RELIABILITY OF INTERNAL MODELS AND CAPITAL RATIOS

Complex banks use internal models to assess the riskiness of their asset portfolios and these models often feed directly into their regulatory capital ratios. Given the importance of capital ratios, the reliability of these internal models is a major issue.

Bank capital requirements are risk-based. The higher the risks a bank is subject to, the more capital it needs to hold as a buffer against future losses. Financial models adjust asset values, so that risky assets are assigned a high value and low-risk assets are assigned a low value. These are known as the risk-weighted asset values (RWAs). An asset deemed risk-free such as a deposit at the Bank of England is assigned an RWA of zero. Banks' capital requirements are based on a percentage of this RWA figure.

Historically, capital rules included standard models to calculate banks' capital requirements using a relatively small number of categories of assets. The differences in risks within the standard categories could be significant. Under Basel 2, the new bank capital rules that were coming into force at the start of the financial crisis, larger and more sophisticated banks were allowed to use more sophisticated measures of risk, based on their own internal models. Basel 2 recognised that large banks invested heavily in financial risk management and should therefore have been better equipped to assess their own risks than banking regulators.

The internal models used to calculate RWAs are often highly complex and can be opaque and hard to understand. They use statistical techniques and large amounts of data as inputs and complex assumptions, in particular assumptions in relation to the potential benefits of diversification or conversely whether risks are increased by high correlation between different assets. Some assumptions are inherently judgemental. Small changes in assumptions can have a significant effect on the outputs of the models.

The post-crisis priority of bank regulators was to tighten capital requirements and introduce liquidity and leverage ratios. They are now looking more closely at the degree of reliability of bank internal models. They have conducted various exercises where they have asked banks to calculate an RWA figure based on a hypothetical portfolio of assets. It has been reported that these have produced significant variations. Further work is underway to identify the reasons for these differences, which could include the fact that banks have different data for similar assets based on their own different experience and use different assumptions in their models. It may be time to reconsider the case for requiring assurance on the operation of banks' internal models, directly by bank supervisors, by internal audit or by external auditors.

The governance and controls over internal models are important in assessing the reasonableness of inputs and assumptions and in ensuring that internal models adequately deal with new products and assets when they are introduced. The complexity of internal models means that it is difficult to detect errors solely on the basis of observing the outputs. It needs an assessment of the inputs and assumptions and how they feed through into the calculations.

Banks use different internal models to value their assets for the balance sheets in their financial statements, as these measure the assets in different ways, so it is not possible to detect problems in the internal risk models from an audit of asset valuations. Banks' internal models are outside the scope of the work of bank auditors and the outputs of these highly complex models are unaudited. There is a continuing debate over whether bank internal models should be subject to assurance from internal or external auditors. ICAEW considering this in the Financial Services Faculty's 2010 report *Audit of banks: lessons from the crisis* which concluded that, at that time, there was little demand from bank boards, investors or regulators to require annual assurance on bank capital ratios.

Bank boards should ensure that there is proper governance and control over their bank's internal models and the principles that underpin them and how their proper performance is assured.

FLAG 3: BANK PERFORMANCE REPORTING COULD BE IMPROVED CONTINUED

CHANGES TO REGULATORY MEASURES

Perhaps as a consequence of concerns over the reliability of bank internal models, regulators are increasingly specifying key model assumptions and inputs. Their directions have consistently increased the amount of capital that banks must hold relative to the risks they take.

Regulators have also moved from using a small number of regulatory measures to using many, including simpler measures such as the leverage ratio, thus further reducing reliance on models. While leverage is relatively easy for the outsider to understand and can be harder to manipulate, it is not a fully risk-based measure. It recognises that risk increases with the relative volume of business, but not that different types of lending have different risks. There is a danger that if the leverage ratio becomes a binding constraint on banks, it could encourage them towards holding riskier assets to increase returns. Although there may be a place for simple measures such as leverage ratios as a backstop against the limitations of our ability to assess risk, the basic principle that capital requirements should vary with the riskiness of underlying assets remains sound.

While the Basel 3 reforms are being introduced over time, regulators are strongly encouraging banks to adopt many of these early. This creates a challenge for banks to control and manage their compliance with multiple measures which can interact with each other in subtle ways that take some time to fully understand.

Recommendations

- The banking sector needs to continue with the work started with the Enhanced Disclosure Task Force (EDTF) to engage with investors to provide better and more comparable disclosures.
- Bank boards need to ensure there is proper governance and control over their bank's internal models and the principles that underpin them and consider how they obtain assurance that the inputs and assumptions into the models are reasonable and subject to effective controls and governance.
- Banks need to improve their systems and controls over regulatory measures and address the challenge of managing a wider range of regulatory targets which interact with each other.

FLAG 4: BANKS NEED MAJOR IT INVESTMENT TO DEAL WITH GROWING RISKS

Banks require major IT investment over the coming years. This challenge is attracting increased attention from bank boards and UK banking regulators who recently wrote to bank chairmen highlighting its importance. IT expenditure is already one of the biggest costs for any bank but much of it is on short-term fixes and immediate priorities. However, technological advances that enable customers to interact differently with banks, increasing security threats and old core systems all point to the need for very large-scale IT investment.

KEEPING UP WITH TECHNOLOGICAL ADVANCES

Technological advances, particularly around the internet, will continue to change the way that banks interact with customers. Banking has always had to change to keep pace with technology and related customer demands. We continue to see examples of this, such as with internet banking and the introduction of new payment systems and mobile phone based transfers.

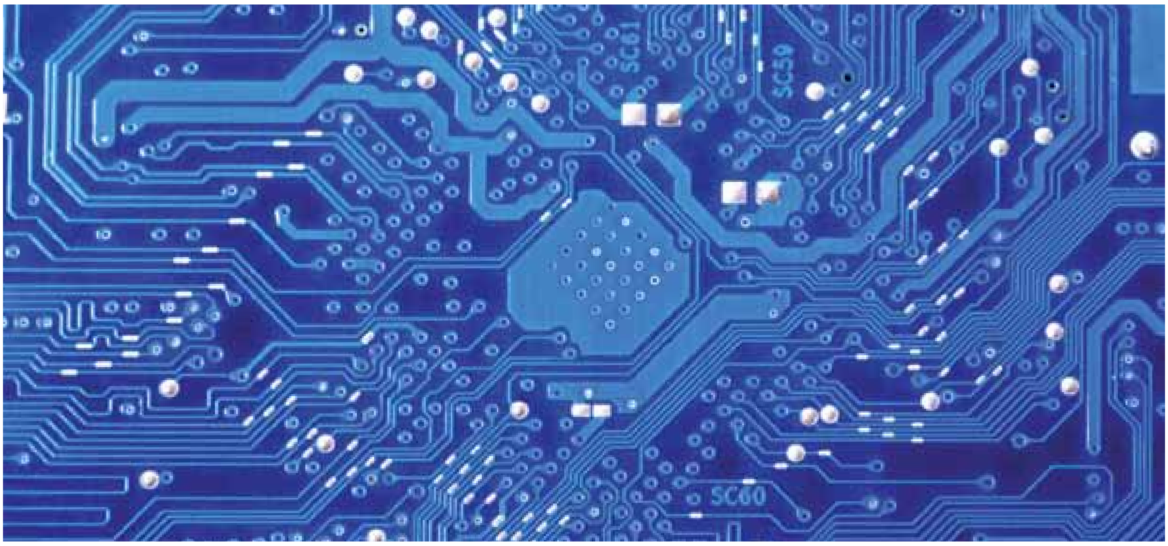
Banks today are very different from the 1950s model, where branch managers were given individual discretion but credit was strictly rationed. And they will look very different in the future. Generations who have grown up online using social media are unlikely to view being able to visit a bank branch as anywhere near as important as older generations. Physical cash itself is already less important. Technological advances are also affecting investment banking activities as cost pressures increase on higher volume products. While not a major part of the scandal, LIBOR did highlight the widespread use of instant messaging between traders, and the need for banks to monitor new methods of communication, including social media.

STRENGTHENING IT CONTROLS

Risks of cyber-crime and money laundering require new ways of working, new controls and significant investment in technology to automate banks' core functions and make them more secure. IT security across all sectors will be the subject of an upcoming *Audit Insights* report but recent attempts to defraud banks and their customers through cyber-theft have highlighted the new threats. These will only increase as customers demand new forms of online and digital interaction with banks.

Banks have to invest heavily in preventative controls as well as in IT to enhance services and efficiency at a time of cost pressures. One consequence is the acceleration of a long-standing trend to centralise IT operations in lower cost locations such as India where there is a large pool of skilled IT workers and a large cost advantage in wages and premises.

However, the operational risks of running technology platforms can increase with distance and geographical separation. At the same time, regulators are becoming more concerned about their ability to unwind failed institutions smoothly and they challenge banks on their ability to maintain



FLAG 4: BANKS NEED MAJOR IT INVESTMENT TO DEAL WITH GROWING RISKS CONTINUED

services in an economy when wider problems in an international group might endanger the ability of the bank to retain the support of an off-shore centre.

Investing in changing IT systems, wherever they are located, is expensive and, as a consequence, most investment is likely to continue to be focused on developments that enhance revenues, reduce operating costs, address pressing business challenges or meet regulatory requirements.

THE NEED FOR INVESTMENT IN CORE IT SYSTEMS

Core back-office and payment systems are of fundamental importance to banks and are vital to ensuring that transactions are correctly processed, that account balances are safe and secure and that proper records are kept. In most banks these systems are old and have been interfaced with many other applications, to accommodate product innovation and corporate acquisitions. While banks spend significant amounts each year on these core systems, they have tended to concentrate on patches to existing systems and on interfaces between systems. **They have under-invested in renewing core systems and no UK bank of any scale that has been in business for many years has an integrated or fully modernised IT system.** The sheer number of customer accounts, the variety of user requirements and the importance of the underlying data means that the cost of replacing core systems is extraordinarily expensive and potentially risky.

However there is increasing risk associated with ageing operating systems and the reducing number of people who are familiar with the original system design and its operating language. The system outage at RBS in the summer of 2012 is an example of what can go wrong and the vulnerability of the financial system to similar – or worse – problems in the future is increasing as the knowledge base erodes and the complexity of interfacing and patching old systems to cope with new needs increases.

Large IT infrastructure projects are notoriously hard to budget and often suffer major cost over-runs. It is likely to cost several billion pounds for a large bank to undertake and deliver such a project. The RBS outage also highlights a further challenge for banks. It was caused by the introduction of a system update. While legacy systems are fragile and inflexible, they are working. Replacing them would risk causing further system crashes which would be highly disruptive to customers and damaging to a bank's reputation, particularly if the payments system is involved. This means that opting to replace core systems is a bold decision for a bank board to take, not least because the long-term benefits may extend well beyond the tenure of the bank board.

The many pressures arising from the recent crisis and its continued fallout suggest that short-term pressures to continue patching up current systems are likely to prevail in the near future. However, over the longer-term, banks will need to make this investment and the longer it is delayed the more the operational risks in the banking system will rise.

Recommendations

- Banks will need to determine the right mix of distribution channels for the future to meet their customers' needs. The historical branch network may still have a place but needs to evolve in a way that meets the needs of a new generation that has grown up online using social media.
- Bank boards should consider whether their IT systems are sufficiently robust and resilient to threats posed by cybercrime and operational vulnerabilities, and are fit for purpose. Boards will need to consider whether they have the right mix of experience and support to enable them to assess this robustly.
- Business cases on IT system investment will need to find the appropriate balance between shorter-term profitability and longer-term security and resilience.

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