From consolidation to trust

Public management letter for the banking sector

December 2014

NBA

Koninklijke Nederlandse
Beroepsorganisatie
van Accountants

NBA

The NBA's membership comprises a broad, varied occupational group of over 20,000 professionals working in public accountancy practice, at government agencies, as internal accountants in organisational management. Integrity, objectivity, professional competence and due care, confidentiality and professional behaviour are fundamental principles for
every accountant. The NBA assists accountants in fulfilling their crucial role in society, now and in the future.

To directors and supervisory bodies in the sector and other interested parties

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Amsterdam, December 2014

Dear Sir/Madam,

The financial crisis has long term consequences for the banking sector. It will take a long time and a great deal of care to restore faith in the banks. Banks are busy redefining their positioning, business model and earnings model. In doing so they need to manoeuvre carefully between the requirements of supervisory bodies and the needs of stakeholders. Supervisory bodes are adopting a new approach. Prudential supervision of banks in Europe is becoming centralised. Stricter requirements are being imposed on corporate governance, solvency and liquidity, culture and conduct. Accountants want to pay more attention to the risks involved in the banking sector and the way in which they communicate these.

We present in this public management letter (PML) 'From consolidation to trust' six signals and recommendations. The signals are intended for directors, supervisory bodies, sector organisations, accountants and other interested parties.

1. Client centered banking requires a new balance
2. Cultural change is still in its infancy
3. Compliance with elaborate regulation requires considerable effort
4. New ratios continue to influence banking policies
5. ICT crucial to business processes
6. The accountant is not visible enough

Banks must use an earnings model which fits the assumption that client's interests are central. This also requires permanent attention to culture and conduct. In doing so, banks have to deal with extensive laws and regulations which affect all aspects of the business. Implementation does not take place without discussion, as is evident from the introduction of new ratios in supervision.
ICT and cyber crime continue to require a great deal of effort and investment.

The latest message is intended for our own members: make yourselves more visible as accountants, show what you are doing behind the scenes and use the opportunities offered by the new auditor's report.

This PML is based on the knowledge of our members who work in the sector. Various stakeholders, including the Dutch Banking Association (NVB), the Confederation of Netherlands Industry and Employers (VNO-NCW) and the Royal Association MKB-Nederland have provided us with their comments. We are grateful for their contributions.

Koninklijke Nederlandse
Beroepsorganisatie
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Yours faithfully,

Drs. Huub Wieleman RA
Chairman NBA

Prof. dr. mr. Frans van der Wel RA
Chairman NBA Identification Board

From consolidation to trust

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Post-crisis banking

The financial crisis and its aftermath are putting accountants and supervisory bodies to the test. Trust in them has declined considerably. It will take a lot of time and effort to restore this trust.

The financial crisis escalated to its full magnitude in 2008. However, the breeding ground for it had been laid earlier. Many Western countries decided, particularly during the 1980's, to deregulate financial markets. In the United States the government promoted the provision of mortgage loans at the lower end of the market. In doing so the basis was laid for strong growth in mortgage loans, derivatives and packaged mortgages derived from them, which would be considered as toxic years later.

Banks and the financial crisis

The banks experienced a gradual change in business processes and culture. Whereas banks formerly fulfilled a mainly public function, their attention was drawn more and more to the profitability of certain financial markets. Publicly listed banks were expected to deliver large profits, which required risks to be taken. The apparently unlimited profit from trade in complex products led to bonus structures which triggered undesirable incentives. For a small group of bankers the goal became the achievement of the highest possible daily result, rather than the monitoring of risks. Only when it went wrong during the financial crisis did it become clear to what huge volumes and risky positions this trading had led.

Due to the optimism in the years leading up to the crisis, the risks of complex financial products were underestimated by consumers, in the expectation that they would deliver high yields. Great demand arose for such products. In their turn, banks did not properly account for these risks in their balance sheets. The ratings of credit agencies appeared in retrospect not to have taken proper account of the actual risks involved in financial products and investments. Very few requirements were imposed on the capitalisation of banks and supervisory bodies had insufficient insight into the financial positions and risks. Accountants assessed the annual accounts of banks on the basis of a relatively new system of reporting standards, without paying sufficient attention to the risks being accrued in various portfolios and the potential consequences for continuity. The duties of supervisory bodies appeared in retrospect not to have been able to prevent a number of banks getting into serious difficulties. These factors combined ensured that various signals were not acted upon.

Government intervention after the crisis

The financial crisis led to a global economic crisis. The limited budget discipline and defective financial reporting of a number of EU member states led to a monetary crisis in Europe. National governments and the European Union had to intervene on a large scale to uphold banks and governments. The taxpayer was required to make a huge contribution to tackle both crises to avoid a descent into economic crisis. The situation has stabilised over the last few years, but the reinforcement of the banking sector requires a great deal of attention. In the meantime, measures are being sought to prevent another crisis in the future. Work is being done on stricter requirements for solvency and liquidity, a tighter lending policy, strengthening of management and change in conduct and culture.

The crisis has led to the introduction of a lot of new laws and regulations and to the organisation of supervision at a European level. The new laws and regulations concentrate mainly on stronger solvency and liquidity requirements. The need for banks to improve capital and liquidity does not relate to the needs of the commercial sector for generous funding in order to stimulate the economy. Banks are spending a great deal of their capacity in re-acquiring a licence to operate. The client must be given more insight into strategy and the balance sheet must be re-written. Change in culture and conduct is a difficult subject. Shareholders will have to be satisfied with structurally lower yields. Tightening and transfer of supervision to the European Central Bank goes hand in hand with a great many requests for information from banks. This imposes great demands on ICT, which must also be prepared for the future and the threats of cyber crime.

International consequences

Globalisation in financial markets and the size of international banks contributed to the cause of the financial crisis. Organisations and geographical operating territories became so large that it became difficult to supervise and manage them. The type of management and operation of a significant number of banks did not measure up to the complexity of the overall operating territories. This must be anticipated by improvements in corporate governance, risk management and a financial safety net by the sector itself. The legislators require a bank which is in danger of getting into difficulties to have a plan to address the situation as swiftly as possible (recovery plan) and in the most serious case to be dissolved as swiftly as possible (resolution plan).

The extraterritorial effect of laws and regulations plays a role in rethinking the activities of banks operating internationally. Banks all over the world have to deal with the cross-border effects of American legislation. For example rules to combat money laundering and re-channelling of criminal funds. Other countries have also developed legislation which has extraterritorial effect or are able to do so. Laws and regulations which are not consistent and whereby a bank can be challenged several times for one violation.

National interests

Dutch supervision is mainly based on European laws and regulations. From the 1980's onwards gradual harmonisation took place between regulations for banks in Europe. The problems concerning the Icesave dispute show that the significance of this harmonisation was overestimated. The quality of supervision and the strength of the economy in the various member states or states which participate in the European Economic Area do not appear to be comparable. It was however a condition for the regulations concerning the European passport, whereby permission in one member state automatically granted access to another member state.

In many countries the events have led to more focus on national interests. All of the attention is now focused on the quality and sustainability of the financial sector. This also involves hidden risks. It is important to have a level playing field within the open European market and beyond. This applies to all of the requirements imposed on banks by legislators and supervisory bodies. A watchful eye must therefore be kept on protectionism and overly strict regulations. The economy must once again be given a chance, without the necessary measures arising from the crisis being weakened.

The strategy in the longer term

The banks are making exceptional efforts to comply with the new regulations. An example of this would be the very detailed reporting to supervisory bodies under the Capital Requirements Directive (CRD IV). The introduction of this requires so much capacity that banks are scarcely in a position to be flexible on strategic matters. What role will banks play in the future in a world which is becoming automated at a very high speed? What products and distribution channels are still to come? Who are the new entrants to the market who will step onto the playing field as alternative providers of banking products? The financial crisis has produced huge growth of shadow banking; activities which serve as an alternative to banking services. These are provided by companies which are only indirectly linked to the traditional financial world. For example investment banks, money market funds and alternative providers of mortgage loans.

Crowd funding has also made its appearance. It provides direct contact between investors and entrepreneurs, without any banking interference. Contactless payment using smartphones is on the rise, for example Google Wallet. In the meantime the bitcoin has become an accepted form of electronic money. Banks must adapt their business model to these new technologies, distribution channels and customer requirements.

Effectiveness of the measures

It may be clear that new laws and regulations were necessary but also that the intended effect of an improved banking system cannot be achieved by legislation alone.

The adaptation of capital and liquidity requirements leads to banks with more capital but the drive toward new ratios takes a great deal of time and effort. More is needed however. The earnings model must be adapted to the new requirements which are imposed on the operation of a bank. It is also necessary that the attention paid to ICT and cyber crime must be more focused on strategic subjects which will benefit the future existence of banks. But the most far-reaching is the need to change culture and conduct. It goes without saying that there is very little room for complacency now signs of economic recovery are beginning to appear. Several large European banks are working to revise their international structure in connection with disciplinary measures imposed by the European Commission. A manageable organisational form must also be sought in which growth and size are not the be-all and end-all. The distance between management and customer has already become too great too swiftly. Simplification of the organisational structure could be a good way to reduce this distance. Banks must also ensure that they comply with the requirement that the organisation can be easily dissolved in the event of bankruptcy so that the risks to creditors and the taxpayer remain restricted.

The research by the central banks into the quality of assets of large banks has been completed. This research took place due to the transfer of supervision to the European Central Bank in November 2014. All of the Dutch banks emerged well from the test.

Dutch initiatives

The Commission on the Structure of Dutch Banks (Wijffels Commission) made worthwhile recommendations in its report 'Towards a serviceable and stable banking system' of June 2013. Banks that are active in the Netherlands should provide all banking products and services in a socially responsible manner which the economy of the Netherlands requires. As a result the banks and the banking system can carry out their functions and they are resistant to shocks. The tightened requirements of CRD IV and the Capital Requirement Regulation (CRR) provide for this.

The Dutch government appears to be stricter on certain elements. The recommendation to promote the development of a banking sector which is as diverse as possible in terms of size, target groups, national or international orientation, ownership structure and country of origin, is in contrast to the strict regulations used by the national supervisory body in particular for banks outside the European Economic Area.

The recommendation to intensify supervision by supervisory boards is worthwhile, however this does not affect the fact that the management of business processes and risks must be firmly embedded in the organisation. In the future a risk management system must also contribute to the formation of the right culture. Even more so, risk management must be integrated in everyday activities and processes. Internal auditors must then, in line with the Banking Code, assess the design and operation of this system and make recommendations where necessary. This requires a high quality internal audit function.

1 The Commission on the Structure of Dutch Banks, under the chairmanship of Prof. H.H.F. Wijffels, at the request of the Minister of Finance investigated how the service provision and stability of Dutch banks and the banking system can be improved.

Signal 1 | Client centered banking requires a new balance

Banks feel as if they belong to us all. Our independence from banks is great: we deposit our money there, the bank takes care of our payment transactions, we borrow money from the bank for the purchase of a house and business owners use them to manage their business finances. The weaknesses in the system were exposed by the crisis. Many citizens feel that banks abused the trust placed in them. As taxpayers they can see that government funding was necessary to save the banks.

The crisis has consequences for the customers of banks. Customers and banks did not adequately supervise the risks involved in products and products were not always suited to customer needs. Homeowners have noticed that the value of their collateral has fallen sharply and, in many cases, is even less than the debt owed to the bank. It was obvious that the government would have to intervene. For mortgage interest to be deductible, periodic repayment is mandatory, whilst the interest on an interest-only loan is no longer deductible. Borrowing money has become increasingly difficult.

Business owners are complaining about the reduced provision of credit by the banks. The increased credit risk is forcing banks to seek business owners to settle their loans or to terminate credit. A business which cannot secure alternative funding may go bankrupt. The financing of commercial property has experienced a very individual development: when during the boom times finance could be secured for more than the purchase price, this has now become 60% or less. High standards are now imposed on the buyer's solvency position.

The fundamental value in the market is determined by underlying rent streams. According to the Valuers and Accountants Platform (PTA) these valuations must be more transparent and must be carried out to better standards. Investing in property is no longer guaranteed to be safe.

More awareness

Government, sector and supervisory bodies are striving toward more financial knowledge of customers, in particular the awareness of risks of financial products. Customers perceive the matter as complex and interest in this is not always forthcoming. Recent case law has referred to increasing protection of the customer if he appeals to inadequate provision of information by the bank when he is financially disadvantaged by a product. A new and clear balance must be found in the division of responsibility between bank and client. This must do justice to the assumption that the interests of the customer are central, but at the same time allow the bank to operate in a commercially responsible manner. Banks are very busy re-profiling themselves from a public point of view in order to regain the public's trust. Reducing complexity and becoming more transparent helps to speed up the purification process. The government must take the lead in this process, along with the NVB and consumer and trade organisations.

With the aid of cultural programmes banks have begun to regain trust. These focus on competences (being able), character (doing what you say), attitude (open and honest) and connectivity (building relations). They are implemented under the control of top management, whereby the interpretation of the 'the central customer' has become the new paradigm. This leads to tension with the banks' earnings models: costs increase and many products have a lower profit margin. In addition to cultural change, improvement of the financial solidity of banks is a significant condition in restoring trust. Alongside this belongs reasonable profitability. Banks must work towards a new earnings model, within a framework to which the customer is central.
A win-win situation must be created; the customer receives a suitable product and the bank earns a suitable profit.
In other words: the quality of a product must be good and the bank may earn from this to the best of its ability.

New technology helps

Banking can become easier for customers through the internet and apps on smartphones and tablets. Due to good technological support the customer has direct contact with the bank. In doing so, what the customer wants must be the leading factor and not the internal organisation and structure of the bank. The application of this new technology may also deliver efficiency and cost reduction.

Ultimately, the intended result of these actions is the restoration of trust and credibility. Corporate social responsibility and social responsibility are based on the sustained trust of customers.

Negative example

Inadequate customer and market-focused approach

Bank A launches a complex savings product onto the market which requires regular action on the part of the customer in order to assess whether this product still fulfils his requirements. A has not thought to inform the customer of these specific features during the term of the product. Customers consider this as a deterioration in their position and A suffers damage to its reputation.

Positive example

Simplification of service provision

Bank B restricts its offer to a top-10 of clear products and services. These are tested in focus groups in everyday language. Even the terms and conditions are clearly and comprehensibly worded. The small print becomes bigger. All of the clauses are explained to the customer and in doing so B tests whether the customer answers sincerely that all of the points discussed are clear.

RECOMMENDATION 1: Updated the earnings model within the framework of customer interests

Banks

- Protect and monitor the implementation of multi-year cultural programmes in order to structurally embed customer interest in the organisation. Test the progress and results including interviews with customer focus groups. Measure the value to the customer from your own perspective and that of the customer.
- Involve customers and consumer organisations in the approval of products and product information. Consider a cooling-off period and more guarantees for complex products.
- Develop a balanced scorecard whereby the customer contributes to the objectives of all stakeholders. Emphasise customer value as an important element of employees' assessment criteria.
- Report on the initiatives and the results achieved.

Legislators

- Develop clear and balanced requirements for the bank and its customers.

Accountants

- Evaluate the way in which the bank promotes the interests of customers in its assessment of risk perception and internal management.
- When auditing the annual accounts, address how the bank promotes the interests of customers and how the bank reports on this matter. Discuss on this in the management letter.

Signal 2 | Cultural change is still in its infancy

The commercial objectives of banks were mainly based on the financial interests of the capital providers and individual employees. The interests of the customer and corporate social responsibility must weigh more heavily in banks' strategies. Long term change programmes are required to fulfil a proper public role and at the same time to bring about a profitable banking business which delivers profit for all of its stakeholders.

A great deal of attention is being paid to the culture and conduct of banks, accountants and supervisory bodies. Nevertheless it remains difficult to finalise improvement plans and to inform the environment about this. Furthermore, a change in culture and conduct requires a critical assessment of the existing laws and regulations because these may not form an obstacle to innovations. An example of this is the arbitration between countries to which different supervisory requirements apply. Bringing about a change in culture and conduct demands a long lead time and more diversity in the make-up of the bank's personnel. It may be quicker if new employees with a different attitude, training and experience are appointed and the management visibly promotes the achievement of the desired culture.

The formal requirements for the right culture and correct conduct are incorporated in laws and regulations. The discussion quickly turns to management, salaries and bonuses. This involves a limited number of banking employees. In the meantime the banks have set up cultural programmes to guide the thoughts and actions of their employees. External supervisory bodies engage behavioural psychologists and assess conduct in the boardroom. Research and advisory committees advise bankers to make promises they can fulfil (for example the banker's oath) and to establish this in mandates, but the question is in what way this oath will be established within the new culture so that it does not become a paper tiger.

Employees and organisation

There must not be a checklist approach to culture and conduct. The actual implementation of changes only succeeds if employees are challenged about culture and conduct, can be judged on it and also know they are vulnerable. Individual performance criteria must be in line with corporate objectives and also provide scope for employees to be appraised negatively. Application of a limited number of clear and strict rules can contribute to the achievement of a change in culture and conduct. Part of the new culture must be that short term financial gain is not the most important element, but rather a pleasant working environment with appropriate remuneration. It must be perceived as a pleasure to meet the requirements of customers in a profitable manner. In the long term, this pays back for the bank and the employee.

A great deal of attention is paid to the tone at the top. Successes in this area are never achieved if the management is not genuinely convinced about doing things differently and acting accordingly. Mistakes from the past are often associated with a dominant leader who was tolerated for too long because he or she appeared to be successful in the first instance. Attention must now be focused on the quality of the group process. Good leadership is evident from group dynamics, the involvement of the correct considerations and the balancing of all interests. The policy must be founded on the wish to serve the interests of customers and social relations in a profitable manner. Not abstract stakeholders but individual customers, business relations and shareholders. A bank must be accountable for many items. Accountability for culture and conduct must receive the highest priority. This can be done in the annual report, where accountability is assessed by the external accountant.

For a long time the formal banking associations, with their manuals, processes and procedures, have not constituted a sufficient basis for good risk management. Due to the crises and the accounting scandals the interest in soft controls has increased. An increasing number of people are becoming convinced that intangible conduct-influencing factors are important management measures. They have an effect on employees' motivation and actions. The usual management measures only function correctly when they are supported by the right culture, suitable conduct and correctly functioning soft controls.

Soft controls must be embedded in risk management and must have a place in guaranteeing ethical behaviour. This requires a great deal of attention and long term planning. The internal auditor must be aware of the importance of culture, conduct and soft controls. The external accountant must involve the culture and effect of soft controls in his audit activities. In several banks internal auditors and external accountants are already working on an approach in which culture and soft controls are integrated with existing activities. Nevertheless, internal auditors and external accountants must make significant progress in this area. It is encouraging that in the meantime these matters have been included in many training programmes for accountants.

The role of supervision

It is also a challenge for supervisory bodies to replace the traditional approach with one in which not only the rules and procedures are examined. The initial assessments by the Nederlandsche Bank (DNB) focus mainly on the processes in the boardroom: attention to conduct and group dynamics, decision-making, dissent and the flexible leadership style of the chairman. Culture however is also present in the dealing room, in the lifts and around the coffee machine. According to the AFM, good conduct mainly involves focusing on customer interests. As is evident from the previous chapter, it is important to have a new and clear balance in how accountability is divided between a bank and its customers.

In October 2014, the DNB and the AFM published a leaflet on the capacity for change of banks and insurance companies. The supervisory bodies of five large banks examined the capacity for change. From this it emerged that there is great willingness to change and that a feeling of urgency exists. It is important for supervisory bodies to investigate the effect of the aforementioned changes on their own objectives. The crisis has demonstrated that the attention paid to risks at an organisational level is insufficient to prevent disruptions to the financial system. Supervisory bodies must therefore collate more information about risks at a macro level, inform the banks of this and explain the measures they are taking to get to grips with them.

Negative example

Incorrect assessment criteria

In the customary audit activities the internal auditor signals that bank C has a large number of inactive customer accounts with a zero balance on its books. This places an unnecessary burden on the capacity of the automated systems and implies an increased risk of fraud. The internal auditor advises the management to close a large number of these accounts. The request is refused because C's account managers are appraised partly on the number of customer accounts in their portfolio

Positive example

Proactive contact with the customer

On the basis of the relationship between the principal sum of a mortgage loan and the indexed value of the collateral, Bank D signals that a number of loans are in 'negative equity'. D contacts customers to try and establish whether this may lead to problems and discusses with them the measures which can be taken in order to prevent problems. The customers are satisfied with the solutions they are offered and D prevents the need for claims to be debited.

RECOMMENDATION 2: Keep culture and conduct high on the agenda

Banks

- Make culture and conduct an essential part of the organisation and risk management. Set up (or continue) a multi-year cultural programme under the direct responsibility of the management, and ask for attention to be paid to changes in the longer term.
- Revise the assessment criteria for management and employees in which culture, soft controls and the long term objectives of the bank are given priority.
- Adopt the desired cultural change and the intended diversity as the assumption in the recruitment and selection of new employees.
- Allow the internal auditor to report periodically on the progress of the cultural programme.
- Report on the initiatives and the results achieved.

Supervisory Bodies

- Focus supervision on culture and conduct on other parts of the organisation than just the boardroom.

Accountants

- Evaluate culture and conduct in the assessment of the perception of risk and internal management.
- Involve culture and conduct, and the accompanying reporting activities, when auditing the annual accounts and report the results of this in the management letter.

Signal 3 | Compliance with elaborate regulation requires considerable effort

Laws and regulations for banks are complex and affect all facets of the business. They are mainly determined by the European Directives and Regulations. The reduction of national discrepancies and the introduction of the European Banking Union will eventually lead to harmonisation. Banks are now facing the challenge to comply with all of the regulations.

In the coming years, banks will once again be confronted by new laws and regulations. The year 2014 showed a peak due to the introduction of the CRD IV, the Single European Payments Area (SEPA) II and many other regulations. Hundreds of technical standards are being worked on at a European and national level, such as the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA), DNB and the AFM. It is justified to ask the question whether the point of optimum effectiveness has been passed along the way. The multiplicity of complex laws and regulations leads to pressure on the banks in terms of the ICT infrastructure, personnel and internal organisation.

Complexiteit

One of the causes of the multiplicity of legislation is the innovation in the sector itself. Because banks are developing more complex products, supervisory bodies feel compelled to amend the rules. Another reason is that a part of the European legislation is the result of political consensus in which national interpretation is permitted.

The basis for the supervisory legislation on capital requirements was established by the Basel Capital Accord of 1988 (Basel I). The document ran to a mere 26 pages. Once the financial crisis erupted in 2008, the Basel Committee attempted to outline all the risks in more detail with its Basel III document. This led to an accord containing 616 pages. The processing of Basel III in CRD IV, the accompanying CRR and all directives and standards which are set up on the basis of this will eventually run to more than 10,000 pages .

The laws and regulations relating to capital are complex. They reflect the wish to base the capital required on a bank's underlying risks. This has advantages, such as the promotion of robust risk management, but also disadvantages, because risks are not always straightforward and should be determined on the basis of objective criteria. It is becoming more difficult for banks to implement changes, as the consequences are difficult to supervise due to the complexity of the rules. Small banks are scarcely able to integrate the rules into business processes and risk management because the costs of doing so are high. The consistent application of regulations and the comparability of banks are in dispute due to the lack of unambiguous definitions and interpretations. Regulations are sometimes inconsistently interpreted and applied by (international) supervisory bodies. An example of this is the unequal weighting applied by member states in determining risks in countries outside the European Union.

The most well-known banks are the large banks, but there is a large number of smaller banks and foreign bank shareholdings operating on the Dutch market. All banks must comply with the same statutory conditions. This can prevent potential new entrants from entering new markets. This results in the risk of the Dutch banking market becoming concentrated on the large banks and other parties leaving or failing to enter the Dutch market. This restricts competition and can have an inflationary effect. A national supervisory body will not be inclined to grant permission to a foreign bank to use funds locally through a shareholding or subsidiary for a foreign group entity with a liquidity problem. The national supervisory body will want to protect the local saver and taxpayer, thus conflicts of interest arise

2 International Convergence of Capital Measurement and Capital Standards, Basel Committee on Banking Supervision.
3 Website DNB.

between supervisory bodies. It becomes difficult for an international bank to allocate capital and liquidity effectively within the company. The European Banking Union must eradicate these conflicts of interest.

More effectiveness

The concentration of supervision in the European Central Bank will have to leave little scope for different interpretations of the laws and regulations by local legislators and supervisory bodies. Uniformity reduces complexity, provided individual scope for national supervisory bodies remains restricted. Only then banks can standardise their processes for the European market. A better balance between purpose and complexity can even lead to the greater effectiveness of laws and regulations.

The timeframes for the implementation of new laws and regulations are short and lead to great pressure on the organisation of the banks. It is important for progress to be made, but that cannot be at the expense of quality. Although the timeframes are fixed, elements of the requirements are often not fully developed. This creates an unstable basis for the banks to adapt their systems. Banks however cannot defer this implementation until more details are available. Analysts assessed banks at the end of 2013 on the basis of the requirements of CRD IV. Within the context of comparability, capital requirements are in principle calculated uniformly for all banks, regardless of their size or the nature of their activities. Consideration should be given to simplifying capital requirements and placing greater emphasis on the size and complexity of the concerned bank.

Negative example

Introduction of laws and regulations delayed

It is unclear to bank E precisely what the regulations are going to be since a lot of laws and regulations are still under development. This leads to uncertainty. As a result E cannot operate efficiently. It is clear that the introduction of new technical standards must be carried out under great pressure because the timescale for implementation is fixed. The likelihood of errors is therefore great. E delays the introduction of new products, because it is uncertain if compliance with new laws and regulations is possible.

Positive example

Compliance with laws and regulations

A central department within bank F monitors the developments in laws and regulations closely and in great detail. The effect of current and future laws and regulations on processes, procedures and systems is analysed. The cohesion between the various requirements is also examined. F is fully aware of the events in the market and what it can expect from the various supervisory bodies in the years to come. As a result the likelihood of non-compliance with laws and regulations is kept to a minimum.

RECOMMENDATION 3: Take the effectiveness of laws and regulations into acount

Banks
- Create a central function which charts all of the developments in laws and regulations and constantly determine the consequences of new laws and regulations for processes, procedures and systems.
- Continue to invest in compliance with laws and regulations; non-compliance is ultimately more expensive.

Legislators
- Harmonise European laws and regulations into a coherent entity, without national liberties.
- Simplify the requirements for banks which are not large or complex, without reducing strictness.
- Use realistic timeframes for the introduction of new laws and regulations based on definitive rules.

Accountants
- Continue to invest in expertise concerning the complex laws and regulations governing banks.
- Constantly assess the consequences of laws and regulations for the bank and the overall audit strategy.
- Within the scope of the audit, report on compliance with laws and regulations in the management letter.

Signal 4 |
New ratios continue to influence banking policies

The introduction of new ratios goes further than a simple calculation of capital and reserves. It urges a new way of thinking and a business model with a good balance between client interests, risk and profit. Banks are seeking a new role in social and economic interaction. A good risk management policy contributes to a sustainable business model.

The financial crisis exposed the fact that banks did not have full insight into the risks they were taking. Banks have learnt the hard way and got to work on restructuring their balance sheet. This included the simplification of their products and forming a clearer view of who the bank is doing business with. In this way, the bank gets a better grip on risks and is in a position to test these against its risk appetite.

The crisis led to stronger requirements for buffer capital (Basel III, CRD IV and CRR). Buffer capital serves as a safety net for unexpected losses and setbacks. It is extra capital, in addition to the provisions already in place on the balance sheet. In order to determine the capital ratio this equity is divided by the total of the risk-assessed assets. The ratio takes into account the estimated risk which is locked into each individual asset, for example credit provision. The legislator stipulates how the ratio should be calculated. For the benefit of DNB the accountant provides a report of the conditions with which the ratio and the supporting information are reported.

Leverage ratio and other ratios

CRD IV introduced the so-called leverage ratio. In the leverage ratio, broadly speaking, capital and reserves are divided by the total assets, the deposited funds. In this ratio the risk of a loan to a large company counts the same as a loan to the shop around the corner. The ratio has two aspects. On one hand it is easy to calculate, cannot be manipulated and is easy to explain. On the other hand it is also a ratio which does not do justice to the risks which are locked into the bank's assets. The leverage ratio is already incorporated in reports to the supervisory body, but is not yet established as a definitive standard. In the years to come research will be carried out into what makes a good requirement on the basis of developments in the banking market, before it is established as a standard.

In addition to the ratios referred to, attention is also being paid to liquidity. Ratios have been developed to bring about better management of short term liquidity by banks (liquidity coverage ratio or LCR), and which strive toward a better relationship between the duration of assets and liabilities (net stable funding ratio or NSFR). More specifically, long term assets must be financed by long term funds and not only by immediately withdrawable savings funds or short term bonds.

It is relevant to monitor the NSFR without overlooking the fact that it is in the nature of a bank for to be certain inequality in the durations of assets and liabilities. The NSFR is also due to be discussed, tested and refined by (international) legislative bodies prior to it becoming established as a standard.

Management by new ratios

Banks must comply with higher capital requirements. This can be done by increasing buffer capital or by reducing the bank's assets, for example by reducing its commercial credit portfolio or its portfolio of mortgage loans. An increase in buffer capital can be achieved by not paying out dividends to shareholders. It can also be achieved by issuing new shares or the subordinating of debt. Capital investors demand a yield which is appropriate to the risks they incur. If they do not get this, they will invest or save their funds elsewhere. This creates a challenge for the banks. How does a bank ensure that it can provide a yield to its capital investors which is appropriate to the bank's risk profile?

A side-effect of attempts to increase the capital ratio is that pressure is exerted on the provision of credit. The total of the risk-assessed assets is one of the knobs the bank can turn. Less credit provision means fewer risk-assessed assets and a higher capital ratio.

The leverage ratio strongly affects the Dutch banks in relation to other European banks. Dutch banks have a relatively high balance sheet total due to extensive portfolios of mortgage loans which can only partly be financed by savings funds. In general, these portfolios have a low risk profile and do not lead to a high capital requirement. Because the leverage ratio does not take into account the underlying risk of the asset, this works out adversely and can lead to the requirement to increase the buffer capital even further.

In finding a new balance between risk and yield, banks are adapting their business model. This model can no longer be based on cross-subsidy between various products and business elements. The pricing of each individual product must be a reflection of costs, a risk premium and a profit premium. This leads to a fair price which may be higher than customers have been used to in the past. Banks must provide clear information to customers about this.

The new banking model requires careful navigation around risk and profit. The bank must seek a risk profile which it considers suitable, along with an appropriate level of profit. Risk-taking is inherent in banking. Integral risk management, in which all elements of the organisation are involved, enables timely adjustments so that the bank remains in control. This begins by carefully establishing the risk policy. The accountant must pay more attention to the way in which this is incorporated in risk management.

Negative example

Incorrect risk policy, disrupted ratios

Bank G has strong growth ambitions and offers high interest rates on savings accounts. These savings funds are used to provide risky credit to the fast-growing dot.com-sector. A huge margin is generated as a result. The capital rules force G to maintain a higher level of buffer capital. Shareholders are very keen to inject extra capital. Profitability increases which appeals to them. What they fail to notice however is that the risk has become too great. When the economic climate worsens, many borrowers can no longer fulfil their obligations. The situation swiftly deteriorates. As a result of media attention, savers' confidence also declines swiftly. G gets into difficulties.

Positive example

Correct risk policy, balanced ratios

Bank H has strong growth ambitions. The bank's risk appetite includes limits for risks according to geography, sector and customer. The yield on credit provided to the dot.com-sector is attractive and H does not want to be left behind by its competitors. H nevertheless abides by the standards which it has imposed: a restricted concentration of risk in one sector. H has some explaining to do to its shareholders when profitability lags behind that of other banks. Because the economic climate is worsening, the dot.com businesses get into difficulties. H suffers a number of credit losses but thanks to its good risk appetite policy, those losses are limited. H continues to produce good results which suit its chosen risk profile.

RECOMMENDATION 4: Use ratios as a boundary condition, not as a basic principle

Banks

- Use ratios as boundary conditions, not as a starting point for strategic policy.
- Analyse the consequences of CRD IV for risks, profit, the balance sheet structure and the business model.
- Determine which products the bank will offer in the future and which customers the bank wishes to serve. Inform customers better about pricing.
- Emphasise the role of the bank in economic interaction and in doing so select a suitable risk policy and an adequate system of risk management.

Legislators/supervisory bodies

- Do not emphasise the solvency and capital and reserves from a restricted number of ratios, but use the new set of ratios as a boundary condition for the total analysis of the business model.

Accountants

- Assess whether the ratios lead to continuity problems or obstacles to business operations.
- Report to the management and non-executive directors on the occurrence of such issues.
- Report the results of analyses and discuss them in the management letter.

Signal 5 | ICT crucial to business processes

The administrative establishment of the rights and obligations of the banks place increasing demands on automation. The distribution of products and services and contact with clients are becoming increasingly automated. This external communication is threatened by cyber crime. The importance of reliable ICT systems is therefore increasing.

The role of banks in society has changed radically. Contact with customers now mainly takes place over the internet. Banks are rapidly moving towards 7 x 24 hour service provision, in which the customer determines how the service is delivered. This development can no longer be reversed as these days, 91% of Dutch people aged between 25 and 45 bank via the internet. The number of debit card payments is many times greater than the number of cash payments.

Developments in the field of ICT are occurring increasingly rapidly, resulting in shorter introduction times and shorter life cycles, but also more chance of teething troubles. Whereas the consumer of 2005 still made use of a PC, the market for smartphones and tablets since 2010 has grown dramatically. The trend towards mobile use is anticipated to continue. Banks must have proper data protection as cash value and privacy aspects are strongly related to this. Customers want banks to handle their details very carefully. The significance of this will increase with the arrival of the European Privacy Regulation in 2016.

Cyber crime and ICT

The traditional bank robber has metamorphosed into a cyber criminal who hacks into computer systems in order to steal money or data or to disrupt processes. Criminals steal from consumers by skimming payment cards, phishing for confidential information and installing malware (malevolent software) on their computers. In conjunction with the NVB, banks try to make consumers aware of the risks of electronic banking, because the safety of payment transactions depends partly on their actions. The consumer however pays more attention to cost and convenience, which is at odds with security.

The borders between the business environment and the outside world are fading as a result of which service provision no longer begins with the physical bank building but at the customer's home. Communication takes place via various intermediaries such as internet providers, telecommunications companies, third party internet pages and suppliers of cloud services. The bank has therefore become dependent on third parties for the reliability and continuity of its service provision, in which the weakest link determines the quality. To provide their services the banks must connect customers to their systems, which are not optimally set up for this. Banks have a relatively old system landscape which is complicated and difficult to manage. It is a challenge to provide quality services and at the same time to transform the underlying processes and legacy systems (antiquated systems) for the new age. Cyber criminals know how to exploit the weakest links in the chain.

Consumers only have limited knowledge of the security surrounding internet banking. Consumer organisations hold the banks responsible for the security of their payment transactions whereas the customer unmistakably plays a role. The use of illegal operating software and the failure to install security updates does not contribute to a correctly functioning system of payment transactions. Customers sometimes give their PIN number to fraudsters, despite warnings by the banks that they will never ask for this. Banks must do more to spread the message that customers also play an important role in safe payment transactions.

In recent years, the banks have been in the news regularly due to DDoS-attacks (Distributed Denial of Services) and the consequences of them for the availability of internet banking. When this happens, the bank's internet site is bombarded with an extreme amount of data traffic as a result of which the site is unavailable or has only limited availability. Although such attacks still take place, most banks have taken measures to limit the consequences for customers.

A new approach

The knowledge and skills of cyber criminals have increased to such professional levels over the last few years, that there is now talk of an arms race with the protectors of the banks in which cyber criminals are adapting their attacking techniques at lightning speed. Cyber criminals are difficult to trace, as a result of which the likelihood of them being caught is very small, whilst prosecution by investigative authorities is very difficult in other countries. The dynamics of cyber criminality means that banks are unable to take on this threat on their own. In recent years the Dutch government has taken initiatives to bring together parties in the public and private sectors to arrive at a common approach.

On the grounds of article 393 clause 4, Book 2 of the Dutch Civil Code, the accountant is considered to report his findings relating to the reliability and continuity of automated data processing. The threats arising from cyber crime must be explicitly included in this.

Negative example

DDoS attack inadequately addressed

Bank I is attacked intensively by a hacker. The attacks overload its systems. I attempts to resolve the problems itself. The IT-management does not inform the management. When publicity arises, the management knows nothing about it. This makes an unfortunate impression so that I's reputation is damaged.
In electing to resolve the problem itself, the bank did not involve the police. Once they were finally contacted, it appeared that they knew all about the offender and the hacking could have been prevented at a much earlier stage. This late action led to significant financial damage to I. I's reputation also suffered.

Positive example

Security arms race

Skimming is the unlawful copying of data on the magnetic strip of a bank card. Criminals do this by placing a device on a cash machine or payment machine, following which money is stolen from the account. In 2012 a sum of € 29 million was stolen in the Netherlands using this method. The losses suffered by customers were reimbursed by the banks.
The banks have reacted in several ways, including the incorporation of a chip in bank cards. Since this measure was adopted, losses due to skimming have reduced to around € 0.6 million in the first half of 2014.

RECOMMENDATION 5: Place ICT and cyber crime high on the management agenda

Banks

- Give priority to the resolution of legacy problems and the risks of outsourcing ICT.
- Inform customers of their role in creating a safe payment environment. Promote the security of PCs smartphones and tablets.
- The board of directors and (the audit committee of) the supervisory board must pay more attention to the risk of cyber crime and its management.

Legislators

- Work closely with the banks to combat cyber crime. Laws and regulations must be modernised and detection must be given the highest priority.

Accountants

- Pay more attention to automated data processing and the threats arising from cyber crime in particular.
- Investigate whether the bank has carried out a full risk assessment in this respect, taken the required measures and whether periodic evaluation takes place.

Signal 6 |
The accountant is not visible enough

The task of the external accountant in banking is unclear to the wider public. The annual accounts are audited and yet a bank can still get into difficulties shortly after. Accountants can play a better part if they provide a good explanation of their duties. The accountant must report more on the key issues and findings of the audit.

The financial world has to deal with more intensive supervision than any other sector. Laws and regulations on supervision require banks to set up an internal audit function and contain a multiplicity of stipulations which are relevant to the external accountant. This requires cooperation between the parties which fulfil a role in it: directors, internal auditors, supervisory bodies and accountants. Each one operates within his own area of responsibility.

According to the BCCI-directive, the external accountant must inform supervisory bodies about certain circumstances which he signals when carrying out his audit activities. For example, action by the bank contrary to supervisory legislation, a threat to the continuity of the bank or not submitting an approved report. The accountant also submits his reports about his audit findings to the supervisory bodies. In addition to these regulations it has been agreed that so-called tripartite consultation will take place. The purpose of this is to share information which contributes to the efficiency of the activities of the parties concerned. Participants in this consultation are the bank (one or more members of the management and the management of the internal audit department), the external accountant and DNB.

The supervisory laws and regulations allow the supervisory body to inform the accountant about issues which are relevant to the audit of the annual accounts or other financial statements. For this reason it is wise for the accountant to enquire whether the supervisory body possesses information which may be important, shortly before signing the auditor's report.

What the accountant audits

The accountant audits the client's financial accounts. For a bank in the Netherlands this involves the annual accounts and other financial statements with which the bank informs the supervisory body of its solvency, amongst other things. In most member states of the EU the accountant does not audit the other financial statements, but in a number of member states the accountant provides very detailed reports to the supervisory body.

With a number of banks the accountant also assesses interim statements. The audit of the annual accounts traditionally focused on past events with the emphasis on historical cost prices or nominal values, except for provisions for bad debt. Developments in recent years have dramatically changed the nature of the annual accounts. The majority of the items in the annual accounts are now valued at current value. A great deal of information is based on models and future-focused information on risks forms a significant element of the notes.

Due to the crisis accountants are often criticised because banks for which the annual accounts had been approved still got into financial difficulties and in a number of cases had to be rescued with government support. Accountants do not effectively explain their auditor's reports and what conclusions can be drawn from them .

A bank acquires exigible funds, based on the trust that these will be repaid plus interest. The bank uses these funds to provide credit to third parties. When this trust is broken, funds are withdrawn by customers and the bank can no longer justify its existence, however good or bad its financial position was. An approving auditor's report does not remove this risk and provides no guarantee of the bank's continuity. Nevertheless, critics of the current auditor's reports must be answered.

A new remit

In consultation with the legislator and other stakeholders, accountants must reflect upon their remit. In researching internal control, much more attention must be paid to culture and conduct, together with the effectiveness of soft controls. The external accountant must bring all relevant observations and findings to the attention of directors and non-executive directors, even if these do not lead to an error in the annual accounts.

A new development in this area is the initiative of the International Auditing and Assurance Standards Board (IAASB) to include a paragraph in the auditor's report containing key points of the audit (key audit matters). In this paragraph the external accountant shows the user the most relevant matters in the audit. The NBA is making this new report compulsory for public interest bodies (PIBs), including banks and insurance companies, with effect from the 2014 reporting year.

Negative example

Defective information provision during the meeting of shareholders

The accountant at bank J is asked a number of questions about his audit policy during the meeting of shareholders. The accountant expresses himself in very general terms and gives the meeting the feeling that he is not providing proper answers to their questions. This leads to a great deal of irritation amongst J's shareholders.

Positive example

Modern information provision about the audit

The accountant at bank K explains the integrated approach to the audit of the annual accounts and the assessment of the sustainability report by showing a video. The accountant points out that sustainability is a strategic element of K's corporate policy. He has responded to this by using a multidisciplinary team to audit the annual accounts and to assess the sustainability report. The accountant also explains the reporting method in the form of a detailed report and its effect on the level of security.

RECOMMENDATION 6: The accountant must make himself more visible

Legislators

- Harmonise within the EU the involvement of external accountants in the audit of reports to supervisory bodies and activities for the benefit of supervisory bodies.

DNB

- Re-introduce the annual bilateral consultation between DNB and the individual accountancy firms concerning developments in the sector and the accountant's involvement.
- Continue the periodic consultation between the NVB, DNB and the NBA concerning responsibilities, cooperation and information exchange. In doing so arrive at the most definitive possible working.

Accountants

- Report in detail to directors and non-executive directors the observations on risk policy and risk management, developments surrounding culture and conduct, the application of soft controls and how the bank promotes the interests of the customer.
- Take active steps to outline the subjectivity of the valuation of non-liquid items and valuation at current value. This can be reported as a key audit matter in the new audit report.


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Summary of stakeholders' responses

At the request of the NBA the following stakeholders have responded to the public management letter. Their responses are summarized in this chapter.

Dutch Banking Association (NVB)

The NVB has read the Public Management Letter with great interest. As the NBA correctly observes, confidence in the sector as a whole has suffered and the actions of banks are being critically monitored by society. There is broad consensus that cultural change is necessary in the financial sector. First and foremost, the change in culture and restoration of trust must come from the sector itself and must be based on Future-oriented Banking. The NVB considers the signals in the management letter as support for this programme and confirmation that appropriate action has been taken.

Signals 1 and 2 are aimed at renewing the earnings model while defending customer interests and keeping culture high on the agenda. With this in mind, the NVB would like to refer to three initiatives: foundation of the Social Statute, revision of the Banking Code and development of a Code of Conduct for all banking employees. These initiatives are packaged together as the aforementioned Future-oriented Banking programme. In terms of signal 3, the NVB would like to point out that compliance with complex legislation requires considerable effort by the banks and other organisations such as supervisory bodies. The NVB wishes to emphasise that the introduction of new ratios is more than a simple calculation exercise. Good risk management is essential, as indicated by signal 4. The NVB believes that the NBA has correctly concluded in signal 5 that ICT and cyber crime must be high on the management agenda. In conclusion, the NVB welcomes the final signal, which states that the accountant must adopt a higher profile.

Confederation of Netherlands Industry and Employers (VNO-NCW) and the Royal Association MKB-Nederland

The VNO-NCW and the Royal Association MKB-Nederland have also read the Public Management Letter with interest. It is important for banks to put the wishes and requirements of customers first. On the other hand, customers also have a responsibility to acquaint themselves with the price-quality relationship of financial products. VNO-NCW and the Royal Association MKB-Nederland note that, in recent years, banks have done a great deal to restore confidence in the sector. The Future-oriented Banking programme and the revised Banking Code are examples of this. It is important to engage in dialogue with society to obtain a better insight into the role and function of banking in society. Accountants can play a role by identifying risks in their management letters or conducting further research.

VNO-NCW and the Royal Association MKB-Nederland wish to respond to signal 3 in particular. Banking regulation is complicated because the various types of legislation are not always consistent and unambiguous, and because more and more regulations are increasing in complexity. It is not beneficial to the commercial sector that Dutch legislature goes one step further than European legislation requires. This creates an unequal playing field with the rest of Europe.

Furthermore, the VNO-NCW and the Royal Association MKB-Nederland have noticed clear cultural change in the banks. Reporting on risk management, culture, motivation and the conduct of employees has become more transparent. Finally, they consider the NBA's new audit report as a significant initiative in providing the public with more insight into the accountant's audit activities.

Credits

Sharing Knowledge

In the NBA Sharing Knowledge policy programme the expertise of accountants is collectively applied to signal risks early in social sectors or relevant themes. In doing so the emphasis is on governance, operations, reporting and audit. In this public management letter (PML) the NBA is presenting six recommendations for banks. This sector is the thirteenth theme to be selected by the Identification Board of the NBA.

A working group of public accountants and internal auditors gathered and discussed anonymous findings. This was then discussed at a sector meeting with stakeholders. The Identification Board then gauged the signals from a social perspective and applied a social assessment to the signals. The stakeholders in the sector were willing to respond in writing to the PML. Coordination and final editing was provided by the Sharing Knowledge programme team.

Further information

A public management letter is one of the publications issued by the Sharing Knowledge policy programme. The NBA has previously published public management letters on: Insurance (2010), Long-term Care (2010), Commercial Property (2011), Greenhouse Horticulture (2011), Municipalities (2012), Charities (2012), VETcolleges (2013), Transport and Logistics (2013), Risk Management (2013) and Life Sciences (2014).Further publications include an open letter on Pensions (2011) and a discussion report about Tone at the Top (2012). All publications are public and are intended for a wide audience.

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