The Scottish Parliament
Pàrlamaid na h-Alba

Official Report

ECONOMY, ENERGY AND TOURISM COMMITTEE

Wednesday 3 February 2010

Session 3

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ECONOMY, ENERGY AND TOURISM COMMITTEE
5th Meeting 2010, Session 3

CONVENER

*Iain Smith (North East Fife) (LD)

DEPUTY CONVENER

*Rob Gibson (Highlands and Islands) (SNP)

COMMITTEE MEMBERS

*Ms Wendy Alexander (Paisley North) (Lab)
*Gavin Brown (Lothians) (Con)
*Christopher Harvie (Mid Scotland and Fife) (SNP)
*Marilyn Livingstone (Kirkcaldy) (Lab)
*Lewis Macdonald (Aberdeen Central) (Lab)
*Stuart McMillan (West of Scotland) (SNP)

COMMITTEE SUBSTITUTES

*Nigel Don (North East Scotland) (SNP)
*Alex Johnstone (North East Scotland) (Con)
*Jeremy Purvis (Tweeddale, Ettrick and Lauderdale) (LD)
*David Whitton (Strathkelvin and Bearsden) (Lab)

*attended

THE FOLLOWING GAVE EVIDENCE:

Bruce Cartwright (Institute of Chartered Accountants of Scotland)
Iain Coke (Institute of Chartered Accountants in England and Wales)
Richard J Hunter (Fitch Ratings)
Richard Martin (Association of Chartered Certified Accountants)
Stuart Paul
Angus Tulloch
David Wood (Institute of Chartered Accountants of Scotland)

LOCATION

Committee Room 5

Scottish Parliament

Economy, Energy and Tourism Committee

Wednesday 3 February 2010

[The Convener *opened the meeting at 09:31*]

Financial Services Inquiry

The Convener (Iain Smith): Good morning. I welcome everyone to the fifth meeting of the Economy, Energy and Tourism Committee in 2010. We have one item on today's agenda: to continue taking evidence for our banking and financial services inquiry. We have three panels to hear from today.

Our first panel is Angus Tulloch and Stuart Paul, who are both in the investment management industry. They are here in a personal capacity; they are not representing any companies. I welcome you both to the meeting. I invite you to make opening remarks, after which we will have questions.

Stuart Paul: Good morning, everybody. It is a pleasure to be here—thank you very much for having us. I will start with a few comments to give you a feel for what Angus Tulloch and I do and where we are coming from.

We are joint managing partners of a business that invests in Asia-Pacific and emerging markets equities. We are based here in Edinburgh. Previously, we were with a private Edinburgh business called Stewart Ivory. That business was acquired in 2000. We are now a subsidiary of the Commonwealth Bank of Australia.

Our company has about 100 people in its Edinburgh office, with another 70 or 80 people in London. Half of our team is based in Hong Kong and Singapore. We are very much an international business, albeit significantly based in Scotland with a strong Scots heritage. Our business is also global from a client perspective. By number, about 75 per cent of our client base is overseas. The majority of our clients here in the United Kingdom are based, ordinarily, down south. We have only one or two clients here in Scotland—Angus Tulloch might comment on that later.

In total asset terms, our team manages a little over $30 billion.

That makes us a reasonably sizeable player in the markets in which we operate. To give you a feel for the commercial dynamic, fees range from 50 to 100 basis points on average in the fund management business. The business as we define it is quite mature. It has existed since the late 1980s, so relative to our markets we are regarded as being quite experienced and having quite a long track record.

I will not labour the detailed comments about the business, but it is worth trying to give you a feel for how we invest money. First, fund management is different from banking and, although we are owned by a bank, we regard the culture and ethos within the business as being quite different. We run what is effectively a business within a business, and we have broad autonomy in the day-to-day running of our affairs.

You might describe our philosophy as fundamental. We are long-term investors. We have a longer time horizon than might be believed from the reporting of the industry in the press these days. Typically, we are looking at three to five-year investments, which, in the quoted market, would be regarded as quite long term. We have relatively low turnover, and we focus on quality, so for us the single determinant of the type of company that we own is a basic assessment of the underlying quality of the business and the integrity of the management team, its track record and so on.

We spend a lot of time meeting companies here and overseas. One of the more significant commercial dynamics of fund management in Edinburgh is the extent to which fund management companies are well served here because of the flow of corporate traffic through town. We can talk more about that: it is important to us and how we go about our business.

That is a little flavour of our business proposition. I am happy to discuss anything that the committee would like.

Angus Tulloch: I have prepared a few points on how I think the Scottish Government might be able to help and grow the industry.

The Government has to encourage better transport links, particularly direct flights from Edinburgh and publicity for them. Heathrow is really a shopping hub through which the people who own the airport direct as much traffic as possible. They are not really interested in promoting direct flights, so anything the Government can do about that matters, because the focus of our business is meeting the management of companies, and we want them to come here. We also want clients to visit us, because the business is very much about relationships. The same applies to through railway services to Europe. Because airport security is getting tighter all the time, going through hubs discourages people from travelling.

It would be helpful if the Government recognised that because our business is very mobile, the tax regime has to be competitive. We have offices in

Hong Kong and Singapore, and our people can move there. When one talks about income tax rates of more than 50 per cent, everything included, people really do start to think about moving abroad. I am too old and have no intention of doing so, but we have younger team members. Only a quarter of our investment team are Scots by origin. Tax makes a difference, however morally justified it is. People are also put off by a lot of the rhetoric about incentivisation in the UK at the moment. Any action on tax has to be co-ordinated internationally.

Because we have to employ the best people, regardless of their origin, diversity is a very important part of the process. A key strength of our business is the ability to move people around offices, but with the increase in bureaucracy over the past three years we have found it a lot more difficult to give people training stints in Scotland.

Improving Scottish education would also help an industry that relies on intellectual curiosity, analytical skills and international awareness. Arithmetic and literacy skills are very important in, for example, support operational services, and there should be more emphasis on vocational education. We have to be very wary of any decline in the reputation of Scottish education. It has been fantastic, and overseas it is still regarded much more highly than I think it deserves to be. The Government should consider introducing an independently and internationally verified international baccalaureate programme.

Financial education in schools is important. That is supposed to be the responsibility of the Financial Services Authority, but the Scottish Government should be much more active in that regard and more prepared to use outside providers. Of course, the industry itself is responsible for making links with universities, but the Government should be encouraged to do anything that it can to help.

Having headquarters in Edinburgh is important for stability and scaleability. I also believe that, as in the electronics industry in Scotland, we need lots of smaller, more dynamic companies that are stronger in intellectual capital than larger process-based units.

Finally, public and local authority pension schemes should be encouraged to give Scottish fund managers a go. We manage only £10 million of Scottish institutional money out of the $30 billion, or £20 billion. I find it quite incredible how difficult it is to be a prophet in one's own country. I am not saying that any favour should be shown to Scottish fund managers, but they should certainly be given a much fairer crack of the whip, particularly with regard to start-up companies. Singapore, for example, has been very innovative in the way that it has encouraged small companies to set up there.

The Convener: Thank you for those opening remarks. Could you consider the other side of the coin and highlight some of Scotland's strengths in the investment management market?

Stuart Paul: First, our international brand and educational and business reputation are still regarded as very strong. Part of that comes down to weight of money. Some very sizeable pools of assets are still being managed here, primarily through the life companies, and that source of capital acts as a commercial imperative for companies.

In my working lifetime, a lot of businesses in the industry have regenerated through spin-offs and start-ups that have subsequently been quite successful, and a number of independent firms have continued to grow. As a result, Scotland's international standing is strong. As Angus Tulloch suggested, that might be partly due to the impact over the past century or more of the Scottish educational system. Certainly the heritage and investment trusts have a strong hand in all that; after all, Scotland was one of the leading investors in the emerging markets during and at the tail-end of the industrial revolution and such dynamics are very well regarded by international investors.

For investors to make money, they have to be prepared to take a different view to that of the consensus—although they should stop short of being difficult just for the sake of it. Scottish firms might have been helped by the fact of their being at one remove instead of being in London or elsewhere. That has probably made it easier for them to step back from the noise.

If you interviewed a dozen people from Scottish management companies, each would probably claim to do things quite differently, but you would get a feel for a commonality between the businesses in their fundamental approach. They tend to be longer term and, interestingly, they tend to be long-only funds—there are very few hedge funds in Scotland. We believe that that is partly because the natural leaning of fund management companies does not lend itself to short-term short selling.

09:45

Angus Tulloch: With regard to the cultural aspect, Scots as a people quite like to be contrary. They love arguing with each other, and that is an important part of our business. I say this carefully, but I think that the Calvinist dimension is important too. There is a degree of loyalty up here: there is much less mobility between companies than there is in London. People work pretty hard, and they do not like losing money. That is very much part of what we do: we are not making fancy new products; we are genuinely trying to work in the interests of our clients.

A colleague of mine has prepared a paper, which we did not submit to the committee but I will leave it here if anyone wants to see it. We think that if Scottish institutions could get together, we could have a code of behaviour. That would be one way of emphasising a characteristic that has an influence up here.

The Convener: Where do you draw your client base from, and how do you go about attracting new clients? You mentioned the Scottish institutional aspect in particular.

Stuart Paul: It is relatively complex in terms of the underlying client base, but I will try to summarise it. We have public offer funds, so it is possible for private individuals here and elsewhere to invest in the pool vehicles that we run. On the institutional side of our business, there is typically a gatekeeper between us and the client. The gatekeeper is often a global consulting firm, which conducts due diligence visits and basic research visits. That involves the firm getting comfortable with our investment approach, and—increasingly, given the turmoil in the broader financial industry—gaining a clear understanding of the commercial and ownership dynamics within businesses.

Giving someone your money to run is ultimately a very different decision from buying a tangible product, and we are very aware of that. We are stewards of other people's assets, and that is not about trying to grow those assets in isolation but about looking after them.

We spend far more time discussing the dynamics of ownership and incentivisation—Angus Tulloch mentioned taxes, for example. We know from people's visits to Edinburgh that they are keen to know what is going on. They read the press and they hear that changes are afoot. Those are important issues for potential clients, even though they might be based a long way away. The clients are sourced very broadly, and we often rely on a positive recommendation from a consulting firm that acts as a gatekeeper.

Angus Tulloch: Pension funds and charities make up the institutional side, which accounts for probably around half of our business.

Stuart Paul: Yes, it does.

Angus Tulloch: We do not do much direct advertising in relation to the retail side, which is probably why you have not heard of us. We manage money for institutions such as Barclays and their clients, all the clearing banks and Fidelity. They have platforms that retailers can go through to put their money into our funds. More than three quarters of our money comes from overseas: the Ohio state teachers fund was our first emerging markets client. We also manage money for three county councils in England, although none in Scotland. We get a lot of money from Australia and a growing amount from the far east, and middle east Governments account for around 15 per cent. We have a very broad base.

Rob Gibson (Highlands and Islands) (SNP): I want to ask about how the financial crisis has impacted on the investment management industry in Scotland, but first I have a follow-up question on the suggestion that it would be a good idea for local investors to think about using local fund managers. Is it possible to compare the success of Scotland's investment management firms with that of others? After all, sentiment is one thing, but the bottom line is another.

Stuart Paul: Two things immediately come to mind. In some ways, our business is the most transparent in the world, because our performance is clearly visible to anyone who has an interest. The counter-argument is that there are lies, damned lies and statistics. As everyone sitting around this table will probably be aware, the industry has asked itself many questions over the years about how it presents information and advertising. Typically, when people want to buy into a certain investment strategy or area, that means that the investment is popular. However, to take the contrarian view, that means that it is questionable whether it is the right time to make such an investment decision. There is often a somewhat inverse logic to such things.

The information is freely available, but people need to be careful about how they use it. Often, people's timeframes are too short when they look at performance data. We used to talk about the need to evaluate fund managers over a complete economic cycle because, arguably, all boats tend to rise with the high tide. Everyone has stories of people who made a lot of money when the market was set in one direction or the other, but relatively few people, unfortunately, have the ability to add longer-term value over a complete cycle. That perhaps prompts the question about how long the economic cycle is—of course, people are starting to redefine it these days—but I think that the principle still holds.

Rob Gibson: In the business insight section of yesterday's edition of The Times, Ben Thomson made much about transparency for investment firms. Can local councils and charities in Scotland access that information easily?

Stuart Paul: The information is available and such organisations will have advisers who have access to it. The question, I suppose, is who provides advice and on what basis fund managers are selected. However, we probably do not have a great insight into that.

Rob Gibson: Thank you.

My question is on the impact of the financial crisis on investment management in Scotland. What has been the impact on your clients? Presumably, many clients have experienced a reduction in income from their portfolios.

Angus Tulloch: The impact has been nil. Fortunately, we have not been associated with what has gone on in the banking sector. We are a very different industry. There has been no impact at all.

Stuart Paul: Fund management in Edinburgh is probably in a stronger position now than it was before the financial crisis. I say that because there are a number of strongly independent ownership structures here. Those independent firms will have prospered with the removal of the worry about parental ownership and what that might mean. Given the type of investment that takes place here—this is a generalisation—it is fair to say that, although nobody thanks us for losing their money, we are measured on a relative basis. In 2008, on average, Scots firms probably did relatively well. We could give a number of anecdotes about companies that performed relatively well through the downturn. In the short term, there will have been a commercial impact, because if assets under management fall, revenues generally also fall. However, in the longer run, we are probably reasonably well positioned.

Rob Gibson: So basically—this relates to the restructuring that might happen in banking—the strength of the investment management industry lies in its diversity and firms' independence.

Stuart Paul: Yes. When I spoke to a colleague from another firm here over lunch earlier this week, he told me that his firm has definitely benefited from being perceived as making absolutely no changes to its head count or its systems. His firm has done no restructuring, which has been taken as a reassuring sign.

Angus Tulloch: We have prepared a short paper—we did not submit it before the meeting, but I will leave it for anyone who wants to see it—that gives personal views on what caused the financial crisis, what its impact will be on Scotland and what can be done. Most of us think that we should focus on narrow banking and that many functions that are in big banks should be taken out of them to be run and capitalised separately, so that the amount of capital against businesses varies according to the amount of risk that people take. For some very risky activities, that might mean returning to a partnership-type structure, under which those involved would personally suffer and lose their houses if they took ridiculous risks.

Rob Gibson: I am interested in seeing the paper that you summarised. Committee members have many questions, so we will move on, but the whole committee welcomes those comments.

The Convener: I will follow up on Stuart Paul's answer to Rob Gibson's earlier question on whether fund managers should be judged on long-term returns. Would there be a problem with that, in that fund managers obtain their business on the basis of short-term rather than long-term results? That produces in the sector a tendency to chase returns rather than long-term value. Does anything in your company's bonus structure result in people chasing short-term returns or is the structure such that that does not happen?

Stuart Paul: The answer to your first question is an emphatic yes. A trade-off—probably the best way to describe it is as a potential conflict—often exists between the commercial imperative and the investment decision.

The answer to your second question is that we have designed a remuneration structure that aligns what we do with clients' interests. In essence, we are paid in three ways. Remuneration has two variable components—both focus on the long term and one has a deferred element.

The first component is a fairly traditional bonus structure that is based on investment performance. Most fund managers would say that the key question to ask is over what period performance is assessed. It is not uncommon for investment bonuses to be awarded annually and based on a rolling 12-month performance assessment. We both argue that 12 months is way too short to make a meaningful assessment. Performance in 12 months often comes down to luck. However, the commercial desire of companies to have the carrot and the stick leads to that short-term focus. In our case, 90 per cent of the variable bonus structure is based on three and five-year investment returns. We have definitely made an effort to recognise the situation and to push the period further out.

The second variable component, which is often missing in other structures, is a link between the business's underlying profitability and the investment decisions that are made. A lot of debate is still taking place in the public arena about the right structure for share-ownership schemes and incentivisation and about whether they encourage one-way risk taking. Having a system such as ours, in which our fund managers think not just about producing investment returns but about retaining capital and ultimately retaining clients in the longer term, is important and guards against people just chasing whatever is happening in the market from day to day.

It is worth mentioning the other aspect of our remuneration structure, which is that any profit-share reward that flows to the team is deferred for three years. While it is deferred, it is reinvested in the funds that we run, so we are very much invested alongside our clients. For most people on the team, that is a significant part of their overall affairs. Those elements reinforce the investment decisions that fund managers are inclined to make.

10:00

Angus Tulloch: Education is one aspect. We have spent a huge amount of time explaining to clients that we report over three years rather than three months. Clients know that they are in for the long run. In relative terms, we have had significant underperformance this year—up 35 or 40 per cent against an index of 55 or 60 per cent—but we have had remarkably few complaints, because clients understand that we define risk as losing money rather than underperforming against a very flawed notional benchmark index.

The Convener: Is your bonus structure a hindrance to the recruitment of good staff, in that people think that they can get more money more quickly somewhere else, or does the longer-term approach mean that you retain staff longer, because they know that the rewards are on the way?

Stuart Paul: It is very much the latter case. Our approach prevents us from recruiting a certain type of investor, but we argue that they are not the type of investor whom we want to recruit in the first place.

I am sorry if I am labouring the point. If you were to ask me what are the two or three key commercial considerations in the business, I would say that the structure has been critical. We have enjoyed a degree of success during the past 10 years and the implementation of the current structure, which took place six years ago, has been a critical contributor to that success.

I mentioned the due diligence that applies to us as managers. It is not unusual for a third of due diligence meetings to focus on exactly the issue that we are considering. Fund managers typically talk a good game, but the ability to cut through all that and say how we are incentivised is critical to clients.

Marilyn Livingstone (Kirkcaldy) (Lab): Has the crisis affected your ability to recruit in Scotland the qualified staff that you need?

Stuart Paul: We have been able to recruit. I will put that in the context of our overall team size. About 25 people are directly involved with the investment team. As I said, roughly half of us are based here and half are based in Asia. We have taken on three people since September—one chap joined us just a couple of weeks ago.

We do not specifically target Scots in the recruitment process. Our team is very diverse in nationality. Scots tend to come up from time to time, but I cannot comment on how easy or hard it has been to recruit Scots. None of the three whom we hired recently is a Scot, but that is a casual reflection rather than anything else.

As Angus Tulloch said, linking the curriculum that is taught in secondary schools to its practical application in the investment world is an area in which Scotland potentially offers quite a lot. We have both been involved in initiatives on that front, not just on basic financial education and understanding compound interest and so on, but on understanding the investment business as an industry. In recent years, a number of firms that focus on the operational side of our industry—the support side—have been successful in growing their businesses here and making the industry attractive to work in. I understand that that success is on-going.

Angus Tulloch: We have been recruiting on the operational, support side, which is mainly locally recruited. Recruitment has continued apace and we are employing more people in both the investment and operational sides than we were employing a year ago.

Marilyn Livingstone: You talked about the importance of having headquarters in Edinburgh. We have heard from witnesses that Scotland's highly skilled staff are a key reason why people locate in Edinburgh or elsewhere in Scotland. However, you said that bureaucracy has increased and you talked about Scotland's declining reputation. Will you amplify those comments?

Angus Tulloch: In common with other firms, I have a number of points to make. We are not convinced that standards of arithmetic and literacy have improved—indeed, in some cases, they may have declined. The comment on bureaucracy was in relation to the need for mobility between our offices, so that people can train with us for a couple of months and then return to their home office. That is important.

Marilyn Livingstone: If the committee were to make recommendations to the Government, I take it that you would want us to ask it to look at numeracy and literacy standards in the school system.

Angus Tulloch: That is correct.

Marilyn Livingstone: Does your company have good links with the Scottish universities?

Angus Tulloch: The answer is probably no, but we are trying to do something about that. I am involved with a group of people and the University of Edinburgh in looking to set up a centre of financial history, given Scotland's huge contribution to the world's financial history. If that happens, the approach will be deliberately pragmatic and not theoretical. Universities tend to be extremely academic in their approach to investment, which is a problem for us. They are very good at producing mathematical models and so forth, but that is not what investment is about. The meeting of minds has been difficult to maintain.

Stuart Paul: We experience a lot of difficulty in moving people around the world. I am sure that that is driven not by anything that is done in Scotland, but tighter immigration policies. For example, it is very difficult to try to bring someone into the country on a two-month secondment. That is the case even if they are part of our team in Hong Kong or Singapore. Anything that Scotland can do to facilitate a two-way flow that broadens the experience of people in this country will serve the industry well in the longer term.

Angus Tulloch: Let us say that a large Chinese pension fund is making its first overseas investment in this country. If we can offer to have someone from the organisation to train with us for six months, we have a huge edge over other people. We are very open to doing that. As much as it is possible to do so, we have people sitting in with us and learning about the business.

Marilyn Livingstone: I return to your links with universities. Graduate training and employment is very important. Are you involved in any graduate training schemes?

Angus Tulloch: The answer is no. We do not do a formal training scheme. We are not big enough to do that. We tend not to employ graduates. If people are going to be internationally aware, we quite like them to go away from Scotland, find out about the rest of the world and get London out of their system. We can put people into Hong Kong and Singapore for a couple of years. We have done that quite a lot. As I said, we do not have a formal scheme. Although we have taken on a couple of people at graduate level that is not something that we focus on.

Marilyn Livingstone: You talked about financial education in Scotland and said that it may be the role of the FSA and the Scottish Government to do that. We have been told that various bodies are working in partnership to look into financial education in Scotland. Has anyone from the FSA asked for your opinion on that?

Angus Tulloch: Not from the FSA. We have spoken to the Scottish Government education directorate—we have had quite a lot of discussion with it—and the Scottish centre for financial education. However, they are interested only if it is home-grown—if it is produced by them. They are really not interested in outside services.

When we sold Stewart Ivory and were bought over, we set up a foundation for financial education. We now provide financial education for about half the school pupils in Scotland, but it is extremely difficult to raise money to continue that work unless the Scottish Government is seen to participate. I have arranged to meet the new Cabinet Secretary for Education and Lifelong Learning to find out whether we can do something, but we had little joy in the past on that because we were not prepared to do the curriculum exactly as the Government wanted.

Marilyn Livingstone: We have heard from other witnesses that sector-specific qualifications are required. You made that point in your opening remarks.

I will ask a more general question. Has there been any long-term damage to the reputation of the financial services sector in Scotland?

Angus Tulloch: None from which it is not possible to recover. It is unfortunate that two banks with Scottish names were significantly involved in what went wrong, but they are regarded as international banks and many of the activities that went wrong were managed from outside Scotland anyway.

Gavin Brown (Lothians) (Con): Do you anticipate many—or any—regulatory changes to your industry in the near future? If so, what concerns do you have about any proposals?

Stuart Paul: I am sure that there will be regulatory changes; we expect that to happen. I imagine—this is a personal view—that there might be far more focus on remuneration structures.

Another area on which we have views and which is commonly focused on is risk and how it is defined. We probably diverge from mainstream thought within the industry, which commonly attempts to control risk by controlling divergence from a benchmark. For us, that is nowhere close to how we should define risk. Unfortunately, it is an easily understood way of trying to control risk, but I am not sure that that is the right direction to push in.

The same is true of remuneration structures—again, this is a personal view. It is important that they be absolutely transparent. If there had been more transparency and more understanding of the implications of certain remuneration structures, certain products would almost have become unsaleable because anybody who really understood what they were investing in would probably not have done so.

Rather than trying to create a one-size-fits-all approach, education, understanding and transparency would be a better way ahead.

Angus Tulloch: The problem with regulation is particular to the retail sector. Because we do not interface directly with the retail customer, we are not so affected by it, but anyone in the retail sector will tell you that the amount of box ticking that goes on is incredible. It is becoming very expensive and the consumer pays for it in the end.

Regulation must focus on the spirit, rather than the letter, of the law. A lot could be done through trying to reprofessionalise the industry to ensure that people behave by genuinely looking after the client and putting their interests first. I will leave the committee a paper in which we have suggested that if everyone in the industry had to take a sort of Hippocratic oath, saying that they would put the clients' interests first and placing themselves under a professional obligation to consider the longer term, that might have a much bigger impact in the long run than ticking the right box.

Gavin Brown: We have had evidence from some witnesses on regulation. One specific piece of regulation—nicknamed the hedge fund directive but, I think, officially titled the alternative investment fund managers directive—has been debated in the Parliament, even though it is a European Union proposal. Do you have any comments on that? Will it negatively affect your industry?

10:15

Stuart Paul: I will talk more generally. The directive's direct impact on our business would be limited, but it would have a significant impact on the investment trust sector in Scotland. I am sure that members have already heard about that. I understand that the proposals threaten self-managed investment companies in particular and that they would be very damaging. Several very large self-managed companies employ a number of people in Scotland, and they would certainly be affected. I know that they are lobbying hard on the directive.

Gavin Brown: In your first answer, you talked about remuneration and risk, which you think might be regulated. You have talked about how your organisation is no worse off—indeed, it is possibly better off—in relative terms than it was prior to the financial crisis. Has its approach to risk management changed at all? Have your risk-management procedures been considered and reviewed, or are they broadly the same as they were before?

Stuart Paul: We are fortunate. Earlier, I mentioned that we have a broad degree of autonomy over running what is effectively a business within a business. Ultimately, Angus Tulloch and I are our business's risk managers. That places a huge responsibility on us, but it also gives us the ability to not make changes to satisfy people in the short term. I would probably give you a very different answer if we were part of a bigger organisation. I am sure that there is a lot of pressure in big, broad-based financial services companies and that many questions are being asked.

As I have said, a framework can be produced in which it looks as if risk is being controlled relative to a benchmark. It is a fact that, three years ago, a UK fund manager would have said that owning shares in every bank in the UK was not risky for the simple reason that they were minimising the divergence of their portfolio against the benchmark index. However, if the benchmark index is itself flawed, that is clearly very risky. Having a commercial environment that allows people to take a commonsense approach to risk is important, but it is quite rare. A number of Scots firms take that approach relatively well. To be immodest, that is certainly something that we do.

Angus Tulloch: Risk should be defined, and losing money in real terms should be adjusted to inflation. That is where people should start from when they consider risk.

Stuart Paul: Another issue that is likely to be put under the microscope is fees. That is completely understandable, but the focus on fees often distracts from the focus on what is fundamentally being invested in. Reducing costs for the consumer is a popular cause and, in some cases, it has a lot of merit, but it is even more important to ensure that the structure of the products or the strategy has integrity and that the end investor understands what they are investing in. It can be argued that people would not mind variable fees as long as they were achieving the returns that they set out to achieve. It is quite easy to produce a low-cost solution, but whether that is the right solution may be questionable. That was tried with stakeholder pensions. It is clear that I am talking from a particular perspective; you are hardly likely to hear me say anything else.

Angus Tulloch: We have a potential problem with capacity because of the markets with which we are involved, so we have closed quite a lot of our products. The problem is that, if you simply do everything with flat fees, some of the better fund managers will be excluded, because there is a limited amount that can be managed in particular markets. Obviously, the best way to ration that is through prizes.

Lewis Macdonald (Aberdeen Central) (Lab): I have a couple of questions. First, I want to follow up on that interesting set of questions and answers on risk. You talked about having a commercial environment that allows a common-sense approach to risk and said that, in simple terms, the approach should fundamentally be about whether money is lost. Would that approach to risk have made a difference to the financial services sector over the past three or four years and, if so, how?

Stuart Paul: If, rather than the absolute performance that a fund manager achieves, they are held to account for their investment performance during periods of relatively short-term underperformance, there tends to be commercial pressure to do something about it. If a certain sector is prominent and is performing well—as the financial industry was two or three years ago—the commercial pressure is great for fund managers to participate in that, even if, on a five or 10-year view, they regard many of the dynamics in the sector as unhealthy. Anything that enables a fund manager to step back and consider whether something is in the clients' long-term interests is good, as that is a healthy question to ask.

I say this slightly tongue in cheek, but the problem is that a fund manager will always argue that they did not necessarily get a decision wrong, just that it has not worked yet. That is why people say that it is difficult to pin down investors and find out what they actually mean, which is why it is important for the process that the nature of the product is understood.

For example, in our business, our emerging markets strategy underperformed significantly in relation to the index for five out of the six years from 2002 to 2008—we outperformed in only one of those years. However, we still delivered real returns of between 30 and 40 per cent compounded, because the market was so strong. A danger would have arisen if somebody had told us to make up the shortfall against the index, as that would have led to our trying to own many companies that we fundamentally did not want to own. The alternative is being prepared to hold our ground and say that we will be rewarded for that stance in the longer term, although we can never say when. We must consider the whole approach, rather than shorter-term considerations.

Lewis Macdonald: The broad issue is of great interest to us. We have had evidence from two or three witnesses that different parts of the financial services sector have almost profoundly different approaches to risk. Could the investment banking sector—which led us into some of the difficulties that we are talking about—learn from the approach that you describe, or is there such a profound difference in what you do that your approach to risk could never be the same as the approach in the investment banking sector?

Stuart Paul: There are areas of overlap and areas of divergence. The areas that overlap revolve around incentivisation, time horizons and reputational risk. Our clients would not expect us to lose money in a falling market—that would be an unexpected result for them. For investment banking businesses, if there were a clearer definition of types of business that they wanted to be associated with, or did not want to be associated with, a different approach could be taken. There is a vast area of business that is very different from the one that we are involved in.

Angus Tulloch: Basically, the investment banks took risks using Government money. At the end of the day, they were going to be bailed out, so the situation was completely skewed. That is a different problem. One issue with investment banking that I feel strongly about and which is one reason for excessive incentivisation is that there is perhaps not enough competition in the business. There are certain oligopolistic practices that need to be considered. For instance, for an initial public offering in the States, there is a standard fee of 7.5 per cent, which is considerably more than the fee in this country. No one has ever explained to me why that cannot be competed down, which is what normally happens when people make huge margins.

Lewis Macdonald: The regulatory function lies elsewhere—with the FSA, the Bank of England and so on, and in carrying out their regulatory reforms they need to learn from other sectors of the financial industry. Should they be learning lessons in rolling forward the Turner recommendations regarding the approach to risk and fund management that you follow—lessons that would be applicable to the wider financial services sector?

Angus Tulloch: The key thing is to focus people on responsibilities to the client, rather than on the short-term transaction. It is debatable whether it is possible to change people's behaviour in that way, but one can have a go, by trying to make people in the industry feel that they have a responsibility.

Lewis Macdonald: As you say, it is a behavioural, cultural issue, rather than one that is amenable to regulation. Would that be fair comment?

Angus Tulloch: Yes, absolutely. If you make more regulations, it just encourages very bright people to work out ways to get round them—and they will, as has been shown over the past year. I do not think that they provide the answer.

Lewis Macdonald: That is helpful.

I have a further issue to pursue. In your opening remarks, Mr Tulloch, you said that the first thing that the Scottish Government could do would be to promote direct flights. You will recall the direct routes fund that operated in Scotland previously, which has not operated for the past two and a half years. Would you support it being brought back, perhaps in a slightly different form?

Angus Tulloch: I should be familiar with that scheme but I am not. It is difficult to know what a demand for something is until the supply is created. Anything that would help for the first year or two years, so that a service can be established, would be very beneficial.

Lewis Macdonald: A route development fund was suspended two and a half years ago because of concerns about European regulation and so on. Those concerns could be addressed. We are concerned with what enables you to do business effectively. Missing out Heathrow is a critical part of that.

Angus Tulloch: Yes—and I am sure that the French could teach us a few ways of getting round such things.

Lewis Macdonald: A fair point.

You will be aware that, in its current round of decision making, the Scottish Government has decided to abandon plans for a rail link to Glasgow airport—and previously abandoned plans to build a rail link to Edinburgh airport. Such links might improve connectivity for your business and for the companies with which you work. Do you think that such things are important to enable customers and clients to come here?

Angus Tulloch: I cannot really comment on their cost effectiveness. There is no doubt that they would improve connectivity, but the Edinburgh tram system shows that one can spend a huge amount on something where there might have been a simpler, lower-cost solution.

Stuart Paul: When we travel to Hong Kong and Singapore we are struck by how easy it is to get there, and then to get into the city. Anything that we can do to mirror their success would be helpful. As Angus Tulloch mentioned, Singapore, which is within our sphere of operation, has been very successful in getting businesses to relocate and in encouraging investment in the core business that it sees as being part of its economy for the next 10 years or so.

Lewis Macdonald: Those models are well connected, with hub airports and rail links directly to the city centre.

Stuart Paul: Yes.

Stuart McMillan (West of Scotland) (SNP): I will start with that point about rail links. Your organisation is affiliated to the Commonwealth Bank of Australia. I am not sure whether you have been to Melbourne, but it is a major city and industry hub, and the transport from the airport into the city is quite excellent without a rail link. I just wanted to get that on the record.

I will go back to the points that have been made about universities in Scotland, which Marilyn Livingstone was asking about earlier.

Numerous courses in numerous universities in Scotland give students the opportunity to study or work abroad, which helps to broaden their international perspective and awareness. I appreciate that that might be for only a semester or two rather than two, three, four or five years, but the message that I got from you was that there are no links and that very little has been done to recruit graduates, whether Scots or non-Scots—the percentage of whom at Scottish universities is high—from Scottish universities. You might be overlooking some excellent graduates who have the potential to enhance your organisation in the longer term. Would you like to comment on that?

10:30

Angus Tulloch: One will always overlook people, however hard one tries. When we recruit, we try to ensure that we advertise internationally. We hope to attract people from Scotland as well as elsewhere. On the operational side, quite a lot of the people we recruit went to university here—about 20 to 25 per cent of the investment team were at Scottish universities. However, any team must be diverse. We need language skills, for example, so we have to be diverse. If we had a recruit Scotland policy, we would cease to be able to compete internationally.

Stuart McMillan: I am not for one minute suggesting that you should recruit only Scots. I studied European business and languages. When I came out of university in 1997, there was a lack of understanding of the course that I had taken and it was difficult to get over to people its diverse nature. Folk from my course struggled to gain employment in the international sphere or work that had a European outlook. There must be a two-way street. Universities and graduates need to sell that aspect and businesses need to sign up to it. I wanted to get that on the record and to get a feel for your views.

Stuart Paul: In our business there are two areas we can talk about—the hiring of investment talent and the hiring of operational talent. My perception is that the industry has done quite a good job in the latter area. Although we have almost the same number of people in the broader business in London as we do in Edinburgh, the vast majority of the operational side of the business is run from Edinburgh. That is testament to the skills pool that has developed here and the ability that exists to build a team.

However, there is still a disconnect in the first area, at investment level. We are slightly wary of some of the academic initiatives to create more of a link between a prominent industry in Scotland and its universities as they tend to become heavily mathematically and quantitatively based. That suits some approaches but not others and, unfortunately, it does not really fit with our approach. It has been interesting to have with us interns from the investment and finance course at the University of Edinburgh but, ultimately, as investors, they would probably not sit comfortably with what we do. Further scope still exists for progress in that direction.

Stuart McMillan's point is well made and understood; it is a link that should be easy to create.

Angus Tulloch: Students forget that there are lots of ways of getting into a business. If we have someone on our operational side who has any interest in investment matters, they are always welcome to attend any of our meetings. It is remarkable how seldom people take advantage of that. Our hours fit in with Hong Kong's and Singapore's so we are in at 7.30 in the morning and it is easy for people to come in an hour early and sit in on the meeting. If they occasionally ask a good question, there is no reason why they cannot move into the investment side if we are looking and feel that they are bright enough.

There is a mindset among students that makes them want to join graduate trainee schemes—where places are extremely limited—and we do not run one. However, there are many different ways of getting into companies. People might feel that they are a little below them, but that should not be the case. Everyone wants to help and to bring up the people who are working around them if they show real enthusiasm and ability, and people are always much happier to employ someone they know, because they have seen them work roundabout them, than someone from the outside.

Ms Wendy Alexander (Paisley North) (Lab): I return to the future of the investment management sector as a whole. You spoke persuasively about the desirability of culture change and not relying on a tick-box mentality as well as about your institution's commitment to looking at the fundamentals of the companies in which you seek to invest, although you conceded that that might not be typical of the entire sector. In that context, next week the committee has the chance to meet Lord Myners, the City minister, who reflected that without significant change, ownerless corporations will sleepwalk into further catastrophe. When looking at institutional ownership, the Treasury Committee described institutional investors as "supine and ineffective". Perhaps such colourful language is less typical of this institution, but the comment raises the issue of what is the right way to address the phenomenon of ownerless corporations and strengthen the hand of institutional investors in the future. I am interested in your views.

Stuart Paul: How long do you have? We both have views on that—I will make one or two comments and I know that Angus Tulloch will too. It goes back to the point about the timeframe for assessing performance and decision making. My personal view is that the industry has got to where it deserves to be in some ways, because as the focus has become more and more short term, there has been less and less interaction between shareholders and executive management teams. As I said at the outset, that is what our business is all about. However, it is a two-way street: if you are a chief executive of a public limited company, you will spend time speaking to investors only if you feel that you have a duty to satisfy and hope to get something back. It should be a two-way street. We should be helping by being a sounding board or providing ideas.

Ms Alexander: How do we incentivise that behaviour to typify the industry more generally and not just individual players within it?

Stuart Paul: To want to do that in a commercial sense you have to believe that, in the long run, understanding a business's strategy and ultimately where it is going will lead you to make better investment decisions. The problem is that if you are being assessed on whether your decisions have worked on a rolling 12-month basis, there is almost no point in having such a conversation because there is no requisite timeframe over which you can be rewarded. That disconnect has definitely led to some of the ownerless corporation-type approach.

Angus Tulloch: On the corporate governance front, we strongly believe that companies that do not look after all their stakeholders—not just their shareholders—will not be good, long-term, sustainable investments. There are a lot of companies that we will not touch, because they do not look after their employees or customers or the community—I am thinking about pollution incidents in China, for example. During the past year we have been partially responsible for senior management changes in companies in which we have investments. We find that discussing such issues helps our investment process tremendously, as Stuart Paul said.

My personal view is that I have no objection to a 10 per cent capital gains tax on short-term investment, as there is in India. Such an approach would encourage people to exercise their shareholder rights more. Lee Iacocca, from Chrysler, suggested that people should hold shares for a year before they can vote them. Consider Marks and Spencer: the future of a strong, 100-year-old British tradition is being determined by arbitrageurs who do not give a hang about the future or the employees and just want to make a quick buck. I do not think that people should be allowed to vote shares unless they have had them for a year—but that is not a common industry view.

Ms Alexander: You have made helpful suggestions on capital gains tax and holding shares.

On another fundamental issue, you mentioned the importance of having headquarters functions in Scotland. Later in the meeting we will hear from representatives of the Institute of Chartered Accountants of Scotland. In its submission to the committee, ICAS talked persuasively about how the movement of headquarters functions away from Scotland results in

"fewer one-off advisory engagements"

and changes, in a deleterious way, the nature of the business of other businesses that provided services.

There has been a significant move of headquarters functions away from Scotland because of what happened to our two principal retail banks. The issue will manifest itself as UK Financial Investments disposes of the stakes that it holds in RBS and Lloyds Banking Group—stakes of 84 per cent and more than 40 per cent respectively. Given the importance of having headquarters functions in Scotland, should UKFI have an interest in whom the ownership of the organisations is entrusted to? Representatives from UKFI told the committee that they do not regard that as a matter for them in any shape or form; they are completely blind as to how the stakes should be disposed of. Angus Tulloch knows the issues that I am hinting at, so I will not go on.

Angus Tulloch: I feel strongly that a local banking sector is important. The sector in Scotland that will be most hit by the loss of headquarters is the charities sector. I am thinking about sponsorship of events and a myriad of activity that we do not see. It is tragic. We are experiencing an age in which big is beautiful, but big is not beautiful at all. People overestimate the economies of scale and completely underestimate the diseconomies of scale. In any disposal of the stakes, it is terribly important for Scotland that there should be local participation—I very much hope that there will be.

It is also about giving people a sense of identity. We always ask companies in which we invest whether their employees have shares in the business. John Lewis is a fantastic example of what can be done when that happens. The issue is relevant.

10:45

Ms Alexander: For state-aid reasons, the EU has forced various disposals in Lloyds Banking Group and RBS. RBS's balance sheet is envisaged to shrink by about 40 per cent. Is there a case for a future Government—after the forthcoming general election—to consider further shrinkage of RBS's balance sheet or further disposal of activities, or should that stop there because the EU went far enough?

Angus Tulloch: I cannot really comment because we focus much more on overseas businesses than on local businesses.

Ms Alexander: My final question is about the way forward for financial services in Scotland. You will know of the Financial Services Advisory Board. The Scottish Government has mooted the idea that Scotland should have an entirely separate equivalent of the FSA—a separate regulatory authority—which could introduce another regulatory authority for organisations that operate from a Scottish base but are UK-wide and global. Do we want to duplicate the FSA and have a separate regulatory authority? Would such a development be desirable?

Angus Tulloch: I ask Stuart Paul to go first. Our answers might differ; I am not sure.

Ms Alexander: That is healthy.

Stuart Paul: I think that I know what Angus Tulloch thinks that I will say, but I might say something different.

I have an open mind on the question. I can see the case for such an authority being made. How the industry is regulated is critical to what can be done to make Scotland a more attractive place in which to conduct investment business. If we were prepared to be brave and to regulate on issues that we think matter, as opposed to tackling the hot issues of the day, and if we put in place a serious regulatory body that set the bar high enough but encouraged businesses to be developed from here, I could see the case for it and would not have a problem with it.

I can—obviously—see the other view, to which Wendy Alexander alluded. Such a body could become just a me-too entity that added another layer of difficulty. I echo Angus Tulloch's comments. We are part of a global business, but the local level is important and we still feel like a small business. Arrangements will differ here. The businesses here are different, for example. A question was asked about the alternative investments directive, which is a classic example of a one-size-fits-all approach that does not really work. Little of the activity that the European Commission is worried about is going on in Scotland. A case could be made for a Scottish authority.

Angus Tulloch: The authority would have to be original and different and would depend on the people who ran it—they would have to focus on the spirit rather than the letter.

Ms Alexander: The original proposition was for regulation light compared with the FSA in the UK. I am not sure whether that idea prevails.

Angus Tulloch: The issue is not whether regulation is light or heavy but whether it is properly focused. One should try to identify, focus on and hit hard people who are clearly misleading the public. Regulation should be light until people show evidence of being irresponsible, when they should be hit hard, rather than having hundreds of people ticking boxes and not considering the spirit of the law.

Ms Alexander: Would it have been easier for a Scottish FSA to confront RBS—whose total balance sheet was 20 times in excess of the national gross domestic product—and to regulate it effectively? We face such challenges. The issue is scale. We celebrate the financial services in Scotland, but the dilemma is that if a country is home to retail banking institutions whose assets are 20 times in excess of the national GDP, that creates a perplexing power balance for the regulatory community.

Angus Tulloch: Does that not suggest that regulation must be international rather than national? The question is not whether it should be Scottish or British. Whatever happens, we must move together internationally much more when we talk about such institutions. Who was responsible for regulating the Icelandic bank system, for example? The issue is difficult.

Christopher Harvie (Mid Scotland and Fife) (SNP): You stress the relatively long-term policies that you pursue in allocating investment, which seems to contrast dramatically with what I have read in the sensationalist press—the Financial Times, in other words—about operations in London hedge funds, for example, where a portfolio might change rapidly over a couple of days. When we interviewed David Nish, from Standard Life, he stressed that a lot of Standard Life's investments were going into private equity, which was not known for unadventurous activity when it comes to changing portfolios. What was your attitude to investment in private equity organisations during the two or three years of the boom that came before the spectacular slump?

Stuart Paul: Almost all of the investments that we make are in the quoted arena, which means that we do not really invest directly in private equity. We have views on what happened in that sector, however, which I am happy to give you.

Again, the terms "hedge fund" and "private equity" probably have negative connotations at the moment, but the reality is that both of those approaches have been around for a long time and there is nothing innately wrong with either of them. However, they are both vehicles that can be used to other ends. One of the failings has been the amount of leverage that they have been allowed to carry, which has had the effect of enabling them to gear up their returns. Another failing involves the fee environment. Following the collapse of the technology market in 2000, people were prepared to take a far more adventurous approach to what they did with their money. Interest rates were reduced to a low level and money was freely available, and people capitalised on that. The time horizons have shortened, however, and the fee structures of private equity companies and hedge funds have increased, as has their leverage in business models. There are private equity companies and hedge funds that have not done any of those things, and will probably still be around in 20 years' time, but a lot have taken a short-term, opportunistic approach.

Christopher Harvie: Do you, as investors, have a readily accessible map of the exposure to particular types of organisation that you would get within a particular investing community such as Edinburgh? Do you have a notion—whether it is based predominantly on anecdotal evidence or on information on balance sheets and so on—of who is heavily into private equity, hedge funds and so on or is that an area where you would just have to suck it and see in order to work out what is going on?

Angus Tulloch: Scottish Financial Enterprise would be the organisation to ask. If anyone ought to know about that, it would. I know only a couple of organisations that manage hedge funds—Martin Currie and Standard Life—and that is a small part of their business in Edinburgh. The organisation with the biggest involvement in private equity is Standard Life, but that is not a huge part of its business.

Stuart Paul: The information is publicly available from the prospectuses that are published. Investors are told what they are investing in. However, whether the average investor understands the nature of what they are investing in is a different matter.

Christopher Harvie: The points that you made earlier about financial education and so on have relevance for any Scottish political structure, because it must provide the infrastructural funds that will supply your needs, for example for trained manpower. Therefore, do you see problems in a situation in which the profit can go into secrecy jurisdictions and the like and not make it back to the place of origin, as is the case in the present system? There has to be some sort of loop whereby the money that the Government spends on providing infrastructure that enables enterprise to function—whether in the form of airports, trained workers or whatever—is returned to the community. However, in our investigations, we have repeatedly come across the fact that the other end of that loop seems to disappear, somehow.

Stuart Paul: My thought on that is that it can be difficult to prove a direct link. Forgive me for using a sporting analogy, but the situation strikes me as being similar to developing youth talent within a football or rugby club. The talent might not immediately flow through to the first team and make that team more successful; it might make its way elsewhere. However, the idea is that, ultimately, the positive flow and knock-on benefits that are produced are a good thing. There are two or three examples in Edinburgh of companies that have spawned quite successful business as people have left one business and set up another one. Ultimately, the investment in those individuals was not necessarily directly to the benefit of the organisation that trained those individuals, but it was of indirect benefit, as it helped to create a more vibrant industry. Certainly, it was of benefit to Scotland.

Angus Tulloch: Private equity funds provide useful operational and financial discipline. We do not have a vested interest in that regard, as we do not run private equity funds, but that is our observation. What I like to see in Asia is a family that controls a business with a private equity shareholder, because that lets you know that they are being watched, so it serves a purpose. A problem arises when the private equity shareholder has excessive leverage, as has been the case in the past, because if it is involved for a three to five-year term, it can squeeze the business of cash towards the end of that period.

Christopher Harvie: One last point, if I may, convener.

The Convener: Please be quick.

Christopher Harvie: The Chinese family could be equated with Hawick, in terms of rugby. It would like to benefit humanity in general, but Hawick first. That is important, and the thing that worries me is the secrecy jurisdictions, which have not been mentioned so far. There are a large number of tax havens into which activities disappear. One knows that something is going on, but it appears that the matter can be settled only by international regulation.

Angus Tulloch: All that I can say is that I know nothing about international jurisdictions.

Christopher Harvie: Not international jurisidctions; secrecy jurisdictions.

Angus Tulloch: I know nothing about either, other than their names.

The Convener: I thank Stuart and Angus for a fascinating evidence-taking session. We could have gone on for considerably longer. In particular, we would have liked to explore in more detail the papers to which you referred. It would be useful if you could submit them formally as evidence to the committee, and we will certainly take them into account in our report.

10:59

Meeting suspended.

11:03

On resuming—

The Convener: I apologise to our second panel for the delay—we took a little longer than expected to hear from our first panel, whose evidence was interesting. In that session, the issue of whether Scottish public sector funds are giving Scotland-based companies a fair opportunity to manage them was raised. It might be worth while for us to write to the pension funds to ask them how they go about selecting their investment managers and what consideration they give to using Scotland-based companies. Is that agreed?

Members *indicated agreement.*

The Convener: I am pleased to welcome to the meeting representatives of the Association of Chartered Certified Accountants, the Institute of Chartered Accountants of Scotland and the Institute of Chartered Accountants in England and Wales, which has a Scottish branch. I ask them to introduce themselves and to make some brief opening remarks, before we move to questions.

David Wood (Institute of Chartered Accountants of Scotland): I am the executive director of technical policy at the Institute of Chartered Accountants of Scotland. I am in charge of all the representation work that we do on behalf of our members and in the public interest.

Bruce Cartwright (Institute of Chartered Accountants of Scotland): In my day job, I am a partner at PricewaterhouseCoopers in the business recovery services department, which deals with troubled businesses—there are lot of them at the moment. I also chair the technical committee of ICAS alongside David Wood. That is my other hat.

Richard Martin (Association of Chartered Certified Accountants): I am head of financial reporting at the Association of Chartered Certified Accountants. The ACCA is a global body for professional accountants with 500,000 members and students around the world. We are well established in Scotland, as more than 7,000 of our members are here. They work in a variety of fields—such as the public sector, and corporate and public practice—as professional accountants. Our global administrative headquarters are in Glasgow. We have a separately constituted branch—ACCA Scotland—which looks after our members in Scotland.

Iain Coke (Institute of Chartered Accountants in England and Wales): I am head of the financial services faculty at the Institute of Chartered Accountants in England and Wales. I am a Scot, but I am based in London. The ICAEW is pleased to come here to give evidence. We have more than 1,400 members in Scotland who work in senior positions in the public and private sectors, so we are well placed to give evidence.

I will make a few opening comments on our thoughts on the crisis. The financial crisis is an economic one stemming from systemic failure in the sub-prime mortgage market in the US, which transmitted on to the wider financial services sector. We are now moving towards economic recovery, but the market remains fragile, as we see from the GDP growth figure for the last quarter—0.1 per cent, which was lower than expected. However, we do our own business confidence monitor, which showed that confidence in the business sector in Scotland was higher for the last quarter of 2004 than that in other parts of the United Kingdom, so we might be about to witness a recovery led by Scottish business.

One of the keys to restoring confidence is establishing trust in financial information. People need good information to make good business and investment decisions, and our members have a key role to play in that. They provide, analyse and advise on information. Therefore, we have an important role in restoring confidence.

Rob Gibson: You just said something about 2004.

Iain Coke: Did I? I apologise. I will correct that—it is quarter 4 of 2009. It was a slip of the tongue. You already have me on the run.

Iain Smith: You have avoided confusing us too much—it is easy to confuse us.

Our questions will focus on two areas: the general impact of the financial crisis on businesses in Scotland; and the role of accountancy agencies in issues such as corporate governance and auditing the banks.

What impact has the financial crisis had on the accountancy profession in general in Scotland and, in particular, on its clients? How is your profession handling those issues?

David Wood: We have 10,000 members in Scotland and a good mix of members in practice and in business. We have not done an up-to-date survey as the ICAEW has, but we did a survey in March 2009 and will repeat that next month. The 2009 survey was of interest. Firms found that their clients were struggling. Many had working capital problems and blamed the banks for the withdrawal of finance.

There is growing demand for advice in the recession. That is sustaining our members in practice. Accountants also have a lot of recurring work, such as auditing and the preparation of accounts and tax returns. That sort of work keeps the practising firms in the profession afloat.

Many of the larger accounting firms have business recovery consultancy arms and, at times of recession when the corporate finance transaction-based work is very low, resource can be moved to business recovery. We therefore have some in-built safeguards against recession in the industry.

Richard Martin: In many ways, the current recession and downturn emphasise the importance of finance functions and properly managed finances—we have seen the same in previous recessions. On the whole, the role of finance in organisations large and small tends to be more important in recessionary times, so to some extent the importance of accountancy has increased.

We are also closely monitoring access to finance by small and medium-sized enterprises. We are doing surveys both across the UK and on a regional basis, so we are therefore covering Scotland. The picture is that Scotland was not as badly affected by the downturn as some other parts of the UK but that there has certainly been rising demand for overdraft facilities and other forms of finance among SMEs as the cash-flow position has deteriorated. In our most recent surveys, the cash-flow picture is looking a bit better; there has been some improvement after the reduction in the earlier part of last year of the facilities available to small businesses.

Scotland shares that picture with the UK as a whole. The particular factor that we notice about Scotland is the dominance of two banks in the market and the fact that there is more competition for SME finance in the rest of the UK. However, that does not seem to have had a significant effect on the availability of finance to SMEs in Scotland.

Bruce Cartwright: Stuart McMillan talked about graduate recruitment earlier. It is very clear that the accountancy profession is not here for the short term: there is a blip, but we are in a transitional period. In the larger firms, mine included, there has been no change in graduate recruitment in the past two years. We are probably recruiting as many people, if not more—I believe that my firm recruits about 80 graduates in Scotland.

The key message to graduates is that we are here for the duration. We do not cut and base our graduate numbers on a two-year programme; we base our decisions on a 10 to 20-year programme, first for our own business and secondly so that we can deliver to the Scottish business community.

Iain Coke: We are increasing the number of banks that are training with us. RBS is one example—it has trained with my colleagues' bodies for some time and has recently started training ICAEW students. As a profession, we are working to increase the availability of training contracts and working with the financial sector as well as within professional practice.

The Convener: I want to pursue the question of credit availability. On the one hand, the banks tell us that they are open for business and that they are approving roughly the same percentage of business loan applications as they ever did but that the problem is that demand is down and that businesses are not asking for the money. On the other hand, businesses are telling us that they cannot get credit, that their overdrafts are being cut or converted into hard loans that they have to secure against personal properties, and that their fees, such as arrangement fees, are increasing significantly compared with what they were in the past. The result is probably that they are not even asking for loans because they do not think that they will get them. From your experience as accountants, which side is right—the banks or the businesses?

11:15

Iain Coke: We undertook research into that in the middle of last year and found that, to an extent, both sets of views are correct. We spoke to our members. Some SMEs are finding it harder to find finance, but there are regional variations, variations among banks and even variations within banks. There may have been some movement of foreign banks out of the UK, so there may be less capacity, but I think that a real element of fear exists. Some people have not wanted to raise issues with their banks because of their fear that terms would be reduced or taken away, or would be less favourable. There was a divergence of views. Some people commented on whether repricing was fair and whether banks were overcharging in difficult circumstances. The alternative view was expressed that the banks were moving the charges to more realistic levels.

Both points of view came through in the information from our members.

Bruce Cartwright: The convener's point resonates with me. When I meet companies for the first time, they often say that their bank manager or bank does not understand them. We often hear people say that they need money for growth. If we get behind the facts, we will get to the real question. Once we get the financiers and companies on the same factual page, we can move forward. Things often start from a misunderstanding. Some smaller companies do not even understand where they are. When someone says to a bank that they need more money, the bank will want to understand what it is for. People often say that it is for growth, but it is often found that it is for funding losses. People will say that they need more money, but if it is for funding losses that will simply go bad, what is the point? One must reverse slightly with companies, get them on the right platform, and ask them why they need the money. If it is for losses, we should tell them to cut out the losses and then look at what they need. Sometimes there are genuine misunderstandings.

Banks are lending. They have gone through a period of reflection. Perhaps the cultural slackness was not only in the business community, and perhaps money was too easy to get. People said, "Let's not worry about the underlying trading performance of the business because of property accumulation and capital." As a society, we collectively forgot some of the fundamentals. Some people are saying that things are difficult, but that is because fundamentals are being applied that people were perhaps a bit lazy in applying previously. That comes into play as well.

Richard Martin: I agree with that; it is all true. All our surveys are done through the Open University business school and are funded by us and Barclays Bank. The overall survey view tends to reflect the business position in a simpler way than the banks' position. There was a distinct drop of around 10 per cent in the facilities that were available in the early part of 2009. We are seeing some recovery from that position, but the drop was noticeable.

People are reporting that costs are greater. People thought that overdraft facilities cost more, but I am not sure that everybody had a clear idea about that; there were quite a lot of don't knows. I could certainly make the report available to members.

The Scottish Government also produced a report, whose findings seemed similar to ours: the percentage of loan applications that were turned down increased in the early part of the year. Quite a lot of the information points in the same direction.

The Convener: It would be helpful if you could provide the committee with a copy of your report. We have seen the Scottish Government report, but it is relatively dated and we want to see what the trends are. Yours sounds as if it might be slightly more up to date, and it would be helpful to have it.

I have one more question on the banks before I open up the questioning to other members. One of the big criticisms that we hear from the business sector is that decision making on business finance has become more centralised and that local managers do not really understand business and cannot make the decisions. That relates to what Bruce Cartwright said. The approach to applications has almost become a tick-box exercise—"Computer says no," like in the "Little Britain" sketch. Do you see that trend? Do you think that increased competition in Scotland's banking sector might lead to change and give businesses more opportunities to find a bank manager who understands their business?

Bruce Cartwright: There is an irony there because some of the time it comes down to pricing. At the lower end of the scale—personal and individual banking—the lower the sum involved, the less there is to move around, and the more it is like a credit application. An individual applying for a £5,000 loan will probably fill in a form as they would do when applying for a credit card. The irony is that the more sophisticated and heavy—"heavy" is the wrong word—or large the lending gets, the more sophisticated the bank's response will be.

From my experience over the years, I have seen that the difficulty comes in when there are larger companies that borrow more. They have sophisticated information systems, so the relationship can be less immediate. However, if a committee or a syndicate is involved, that is fine. I have always felt that the system disconnects in that middle market, in which a business that is borrowing £2 million to £4 million might not produce regular accounts, which does not help. Such businesses might not be quite big enough to have robust systems in place, so the bank is very reliant on the individual who, ironically, is the one who needs the most help, but the most help is actually available to the larger companies and the smaller guy who is making his credit application. That is where there is a disconnect.

I understand why the banks have centralised things; it comes down to cost. The customer wants to pay less for the service, but he also wants the service to be personalised. That applies not just to the banks but across the retail sector. There is a disconnect in the current situation. It would be good to have someone to turn to immediately in your own city—Dundee or wherever—but that has to be balanced against the economics of the business. That is no different from shopping: people prefer to talk to a human being.

Richard Martin: The banks have business branches and managers, so there is someone to talk to. However, I completely agree with Bruce Cartwright that banks set thresholds below and above which applications are dealt with differently, and different information is demanded at different thresholds. It is not surprising that banks do things differently with applications and on-going monitoring according to how much money they have out there.

The Convener: From what you have just said, is there a gap in the business advisory services that are available to small and medium-sized enterprises? If there is, who should be filling it? Should it be the accountancy profession, the business gateway, Scottish Enterprise, or someone else?

Bruce Cartwright: It is funny that you should ask that. I am sitting here as a member of ICAS and thinking that there are ICAS members in local communities all over Scotland. For example, in the farming community, it is obvious that people talk to their accountant. Sometimes we have to be fair and say that people like getting free advice; they do not like to pay for it. There is a natural network, but it is a two-way thing. A small business with a £2 million loan might not do its accounts regularly and might not be able to give facts and information. People are sometimes reluctant to turn to a lawyer, an accountant or professional adviser because the clock is running, but there are probably ICAS members in every location in Scotland. I do not want to brag about ICAS, but the professionals are out there, and perhaps they are underused.

Iain Coke: Our experience is that, for many SME businesses, the accountant is often the trusted business adviser. Such a business will probably have a lawyer and an accountant, even if they do not produce or audit the accounts. Most businesses of a reasonable size—I am talking about the £2 million-plus level—will have an accountant as an adviser. Perhaps they could talk more to their accountants to get help through a period of crisis.

Rob Gibson: We have been talking about competition. In its submission of last September, ICAS said:

"many of the relationship managers at banks have either been replaced or no longer have the authority that they previously had".

You have partly covered the issue, but from the point of view of competition, surely that does not amount to reaching out to the sector that we have talked about. Are we saying that accountants can take the place of local relationship managers in banks?

Richard Martin: No, I do not think that they can. They are people who can advise customers. As has been said, surveys in many countries indicate that accountants are among the most trusted business advisers. The fact that that helps to give the banks confidence in them means that, to an extent, they are trusted by both sides, partly because, as a profession, accountancy has a dedication to integrity, ethics and so on. That is accountants' role; they cannot replace the banks' relationship managers.

Iain Coke: Accountants may be akin to translators, in that they help to bridge the information and knowledge gap between small businesses and the banks.

Rob Gibson: The role of auditors has come under greater scrutiny as a result of the financial crisis. Do you have any comments on that?

David Wood: The role of auditors is extremely important, as it is about giving confidence to capital markets in relation to financial reporting. There have been some challenges.

I should explain that financial statements are the responsibility of the company's directors, who make estimates and judgments on the valuation of assets, provisions for losses and disclosures within the constraints of accounting standards. The role of the independent auditor is to examine those judgments and financial statements and to provide an independent report that gives confidence to the markets.

The auditor's role includes consideration of a 12-month period from the date on which they sign their report. They must consider the company's situation as a going concern over that period, so they would naturally think of various events that could happen that might have an impact on that. They would look at the company's forecasts and its business model for the period. Things could crop up that are not anticipated, as happened in the financial crisis, so the auditor cannot guarantee 100 per cent that the company will remain a going concern. That is one issue that came up in the context of the work of the Treasury Select Committee at Westminster.

Two other issues came up, one of which was whether, even though the auditors did the job that they were expected to do, the audit should be broadened to make it more useful. I am sure that Iain Coke will be able to fill us in on that because the ICAEW did a project to take that forward. The other issue was the provision of non-audit services by auditors to their audit clients. ICAS did a project on that, which I would be willing to talk about further in due course, if you wish me to.

11:30

Richard Martin: Obviously, whenever there are major financial losses, questions are asked about audit and the role of auditors. We have seen that in previous crises with Enron and so on. Our view is that the auditing and accounting profession of course needs to look at what has happened to see whether any lessons can be learned. We are certainly doing that—not just in the UK but in other countries around the world—and we are considering whether the audit should look at wider issues. However, we come back to the position that the audit is on the financial statements, which are historical records. That is an inherent limitation in financial reports and in the audit of those reports that we cannot get away from.

Iain Coke: Further to Richard Martin's allusion to the post-Enron reforms, we have gone through a significant strengthening of the accounting and audit regulatory system over the past few years, so we perhaps arrived in the current crisis in relatively good condition. I think that those reforms have held up quite well. Press reports in early 2008 about the performance of auditors indicated that auditors were being quite strongly challenging of management—which is what one would want them to be—and that auditors were doing their job under quite difficult circumstances.

Rob Gibson: David Wood referred to the non-anticipation of the sub-prime mortgage crisis. Given their understanding of collateralised debt obligations and the like, surely sub-prime mortgages should have flagged up dangers in the minds of auditors ahead of time. Were challenges being made to management about such financial investment structures, which were proliferating in the market at the time?

Iain Coke: At the start of 2008, there was a challenge in valuing assets and liabilities in stressed markets. Responsibility for doing that lies with management; the auditors review the judgments that management have made in putting together the year-end accounts. That was quite challenging for the auditors, whose job is not to decide on or report on the business model that the management use but to report on whether the accounts present a true and fair view of that.

Richard Martin: I emphasise that the audit is a true and fair view at the balance sheet date. During the crisis, we know that events moved extremely quickly. Although some investments were difficult to value—there were many problems with that—investments that were being traded at a particular value subsequently saw their value diminish significantly over a matter of a few months. Therefore, very big losses were incurred by some institutions. However, on the whole, the picture that we now see is that those losses were recorded in the right period. I do not think that we have seen lots of cases in which the values that were attached at the balance sheet date were necessarily widely out or wrong. The values were right at that date, but events changed subsequently. In those few months, major losses of value were incurred that had to be recognised.

Rob Gibson: Following on from that, have any changes been observed in the demand for auditing and accounting services by headquarters of financial institutions in Scotland?

Iain Coke: I can probably offer comments on the UK more generally, rather than on Scotland—

Rob Gibson: It would be helpful if your comments relate to Scotland, as we are trying to focus on what is happening here.

Iain Coke: I do not expect that there would be any difference between the UK position and the Scottish position.

A lot of the major firms' financial services practices have commented that they have never been so busy. Some of that will be because they are providing audit services to their audit clients, and some will be providing non-audit services to, and doing advisory service work with, non-audit clients. In the financial services sector in particular, there has been a lot of demand for the skills of accountants and auditors.

David Wood: I endorse that. Audit is a statutory requirement anyway—certainly at the top level. Lower down, there is auditing exemption for the lowest companies, so demand for audits at that level is slipping away slightly.

Rob Gibson: So, it is a good time for auditors and their profits.

Bruce Cartwright: It is not necessarily a good time for auditors. They might be busy, but that does not mean that the market is not competitive. I would like to think that any profession has a revenue stream to support it, but it is not as simple as saying that this is a profitable time. It is a case of having a business that will be sustainable for the next 50 to 100 years. It not about making hay in one year, but about how a firm stays in the business over a lifetime, as with any business.

Richard Martin: There has been quite a bit of change between different parts of the business, and we have seen that in previous recessions. The audit is clearly an on-going requirement, so the demand for it remains fairly steady, but demand for other services, such as tax advice, tends to diminish in a recession, while business recovery services tend to increase. The picture is one of different professional service firms growing at different rates.

Rob Gibson: The headquarters of financial institutions in Scotland, the asset managers, insurance firms and so on, as well as the banks, are all seeking your services. Is there any noticeable difference in that demand just now? That was the root of my question.

Bruce Cartwright: From observation of our businesses, I would say that there is a demand for the services. Is it higher than before? The transactional work has changed, perhaps temporarily. There is less corporate finance work, and more transaction work of a different nature in my area. Within that, tax services seem to be more focused on transactional corporate finance. If any part of the industry is finding things slightly more difficult, it is the tax advisors within the profession because there is less transactional work and less merger and acquisition activity.

Lewis Macdonald: I go back to the audit issue, and ask for a little bit more clarification of the audit process in a major bank, for example. What will the auditor do, and to whom will it give account at the end of the examination of the accounts?

David Wood: I will give you a brief introduction and perhaps others will supplement it. The most important thing for an auditor is to understand the business. In planning an audit, that understanding is vital when the auditor is looking at the riskiest areas. The auditor normally approaches their work on the basis of risk and, because the concept of materiality features highly, the auditor focuses on the largest and riskiest figures.

Audit work involves checking financial controls in the business, which applies to all companies—not just banks. The auditors might run through a sample of transactions in different areas. They also scrutinise in great detail the financial results that are being reported, and try to match those to their understanding of the different patterns and seasons of the business. They also undertake a detailed analytical review of the financial statements. In a company such as RBS, for example, which has a US listing, the auditors also work on internal controls under the United States' Sarbanes-Oxley Act. At the end of that process, the auditors complete a report to the shareholders, which is expressed in terms of the accounts as presented, and which gives a true and fair, or roughly right view.

As I mentioned before, there is a going-concern aspect to that.

Do you want to add anything on the financial services side, Iain?

Iain Coke: It is important to remember that the auditors of a bank have exactly the same job as the auditors of any other institution. They have only limited responsibilities in relation to the FSA and on the regulatory side. Therefore, if a bank auditor or an insurance auditor becomes aware during the course of their normal audit work of anything that the regulator ought to know about, they have a statutory obligation to report that to the regulator.

However, their main job involves examining financial statements. They do not have responsibilities over bank regulatory returns, so they are not required to get an audit on the financial information that banks provide to the FSA. That is different to the way in which insurance regulation works: insurance regulatory returns are on the public record and are subject to audit, whereas banking returns are private and there is no audit requirement in relation to them.

We think that there is scope for examining the relationship between auditors and the FSA. That is an area that we were asked to examine by the Treasury Select Committee, and we are going through a process of stakeholder interviews with investors, bank chief financial officers and audit committee chairmen.

Last week, we met John McFall to talk about the demand regulators, and we think that there is scope for more to be done in that regard; there is, in particular, scope for bank auditors to have greater dialogue with the FSA. Under the previous regulatory regime of the Bank of England, there were regular meetings between bank auditors and the Bank of England. We think that more use could be made of such meetings. The FSA has increased the frequency of its meetings, and is committed to an annual meeting between a bank auditor and itself, which is not that frequent for a major bank.

As well as meetings, there should be a good and open dialogue that involves not only the auditors giving information to the FSA but the FSA sharing with the auditors information that might have an impact on the audit assignment. For example, there is no requirement for the FSA to tell the auditors that it is about to shut down a bank, even if that were scheduled to happen the day before the audit report were signed. We think that that is a weakness in the current regime. It is different to the position in the USA under the Federal Reserve System, where there is a duty for regulators to give information to auditors.

Richard Martin: I would emphasise the importance of shareholders. The financial reports of the companies are designed to inform shareholders, the market and investors such as the people you heard from earlier, and the audit follows the financial reporting because it is an audit on the financial reports. The auditor must always remember that he is responsible to the shareholders of the company, not to the company.

Lewis Macdonald: That is a relevant point. Numerous witnesses from various sectors have stated that a critical feature of the crises that hit HBOS and the Royal Bank of Scotland was the failure of non-executive directors in particular, and of the board in general, to pick up on the risks that had got out of control, and to rein in the executives who were clearly taking outrageous risks with other people’s money. What is the role of the auditor in that situation? If non-executive directors and shareholders fail to recognise overly complex financial instruments, risk that is out of control and acquisitions that are not in the best interest of the acquirer, is the auditor responsible for alerting non-executive directors and shareholders to those issues before they arise?

11:45

Richard Martin: The auditor has no role in communicating with shareholders beyond the question of the truth and fairness of the financial statements that are issued. We have to remember that that was in train before the financial crisis. Those financial statements now try to communicate much more the sort of messages that you are talking about, such as taking on risk and the strategies and sorts of business models that banks and other companies are pursuing. That information is increasingly in the financial statements. There is a responsibility for the auditors in that regard.

Auditors prepare more lengthy internal reports to audit committees and therefore to the boards of directors of companies on what they see as important issues that have come out of the audit or important decisions that are being made by the company about valuation or whatever. So, there is another form of reporting that is private, as it were, to the directors via the audit committee.

Iain Coke: Auditors are not there to second-guess management and they do not have a particular duty to look for risk problems, other than those that relate to risk of misstatement in financial statements. However, the auditor might become aware of things in the course of the audit report: if so, there is a duty to report that to those who are charged with governance. The typical route is through an audit committee. Auditors are not necessarily required to look for everything, but if they become aware of problems there are obligations to report them.

Lewis Macdonald: Would reporting to the audit committee be on a separate channel from the ordinary conversations with the chief financial officers that you would, I presume, have on a daily basis during an audit?

Iain Coke: Often, it would happen in both ways. The auditor would only not tell the CFO something that he was going to tell the audit committee if there were particular concerns about the actions of the CFO. It would be unusual not to inform the executive management. Typically, it would happen in cases of fraud with which the executive management is associated.

Lewis Macdonald: What is interesting is that the auditor is better qualified to understand the financial processes within a company than almost any other independent external person. Have auditors' professional judgment and understanding been fully utilised in respect of financial sector organisations that have got into difficulties such as we have seen?

Richard Martin: You are right that auditors must have an overall view of often large and complicated institutions and that there is something in that position that could be useful. As I said, the financial statements have to talk about how the company manages its various risk exposures and about the nature of its investments. All that has to be covered as part of the audit because it is in the financial statements and, sometimes, in associated documents that the auditors are responsible for examining.

Iain Coke: We need, however, to be realistic about how far auditors might be able to go. They have financial skills that they use in looking at and reviewing internal control processes, but they are not economists, nor are they better able to predict the future than anyone else. There is therefore a risk that if we oversell their role, we might create an expectation gap with regard to what can realistically be achieved.

David Wood: I have a point to add on corporate governance. The auditors also have a role in ensuring that disclosures that relate to corporate governance in a company are fairly stated and not misleading. That would not extend to comments about the non-executive directors not being challenging enough; it relates more to structural matters. That is another important role of the auditors.

Lewis Macdonald: Would it be true to say, as I think John McFall said, that the number of firms that would have the range of skills and knowledge to audit effectively the large financial institutions would be quite small? Is that a fair comment?

David Wood: Yes, that is right. We are talking about very big financial conglomerates with global operations. The number of firms of similar size with expertise to match is fairly small.

Lewis Macdonald: Such expertise would be available in Scotland—if a Scotland-based institution were being audited, a Scotland-based auditor would be available to do that.

Bruce Cartwright: Yes. I can state categorically that such expertise exists in my organisation.

Lewis Macdonald: I knew that you would say that.

Iain Coke: There is a so-called big four of accounting firms. Other organisations are looking to get into that market, but the focus is on the big four.

The Convener: I want to press you a bit further on the true and fair nature of financial reports, because it seems to me that that is the crucial issue here. I presume that in producing such reports, you must be satisfied that you understand the nature of the risks that the banking industry has undertaken. It appears, from the crisis, that some banks were not clear about the nature of the risk that was involved in the cut-and-sliced instruments that they were dealing in. Are you satisfied that the auditors understood the nature of the assets that were held by the banks—in particular, the toxic assets that are now costing the taxpayer a fortune?

Iain Coke: We have accounting standards to help to describe the type of risk disclosures that are needed. Recently, the level of disclosures on financial instruments has increased and been strengthened. "International Financial Reporting Standards 7—Financial Instruments: Disclosures"; which deals with disclosures on financial instruments and covers risk disclosures among other things, came in for the first time for 31 December 2007 year-ends, which was probably slightly too late for the current crisis. The accounting profession has been looking to strengthen risk disclosures over the past few years.

Richard Martin: With many such instruments, it is a question of what the value of those instruments was. That is what I was trying to say. Such instruments have a value on a particular date, which is a true and fair value on that date but not at a subsequent date, so a great deal is caught up in the valuation that is put on them. The valuation that was put on the instruments in question was put on them by the management and was based on transactions that might have been taking place on similar instruments. There are specialist firms that value such instruments. It is accepted that the market priced some of those instruments incorrectly: it did not understand the risks, so it got the valuation wrong.

Bruce Cartwright: Richard Martin is right about valuation, but even if we move away from considering instruments—in order to make the issue more tangible for people here—and look at the property market, which people can see and feel more readily, we see that the values that were put on property were correct at that point in time. An irony is that the financial crisis was a liquidity crisis but, because that made people lose confidence, there was an almost self-fulfilling expectation that property prices would begin to move downwards due to lack of liquidity. For example, values in the commercial property market are probably 50 per cent of what they were two years ago. I do not think that people would have predicted that sort of correction. I find it easier to consider the issue in the context of the property market because I can see and feel it. Property prices were not previously wrongly valued—people were willing to pay those prices for property, although they would certainly not pay the same price today. Values will come back, but it might take seven or eight years.

The Convener: I want to press you on that because, to my mind, you are mixing up price and value. The price of something is what someone is willing to pay for it, but that is not its value. For example, if I was foolish enough to buy a fake painting, I could pay a large price for it but it would not actually be worth anything. Did the people in the accounting industry who were auditing the banks understand the underlying value—as opposed to the price, which we all know was wrong—of the assets? Did they understand the risks that were contained within those assets in a way that enabled them to say that they had been given a true and fair value, as opposed to a true and fair price?

Bruce Cartwright: Before answering that question, I need to be clear that, if someone is willing to pay the price, that is the value that they attribute to the asset. I am sorry to disagree on this—

The Convener: Auditors are meant to check that the value that the banks have put on something is a true and fair value. That is for the benefit not of the bank but of the shareholders. If the value is completely wrong because the underlying risk related to the asset has not been properly assessed, surely the auditors have a responsibility to highlight that. If the auditors do not understand the underlying risks and therefore do not understand the value, surely they have a responsibility to highlight the fact that the assets are such that it is impossible to assess whether a true and fair value has been given to them because the auditors do not understand the meaning of them. That is what I am trying to get at. Did auditors understand the assets that they were valuing as part of the audit process?

Iain Coke: Price is probably the best and most objective indication of value at any point in time. Yes, price and value are different, but price is an objective measure whereas value is a bit of a theoretical concept.

David Wood: Perhaps a linked issue is that the market for some of these instruments was fairly thin. In that respect, it is actually quite difficult to say that price is a realistic value, but there is nothing else to go on. Value obviously exists in the eye of the beholder, so the market price is the most reliable. The other side of the issue is that financial statement users need to understand and be aware of the limitations of the accounts in that respect.

Gavin Brown: Clearly, auditors look at the balance sheets of companies and organisations. To what degree do auditors have discussions with institutions—financial or otherwise—about what is not on the balance sheet?

Iain Coke: The International Accounting Standards Board has been looking closely at off-balance-sheet issues over a number of years and has tightened up what goes on to the balance sheet. The IASB chairman, Sir David Tweedie, is on record as saying that he will feel that his job is done when British Airways has its aeroplanes on its balance sheet. There has been an on-going process at looking at what is on and off balance sheet.

In the current crisis, in the context of financial instruments and securitised vehicles, there was a problem with the definitions under US generally accepted accounting principles—GAAP—that was fixed in the crisis. However, we did not see particular problems in the international financial reporting standards definition of whether things are on or off balance sheet.

12:00

Richard Martin: I agree. Obviously, the UK and the other European banks have been using the international financial reporting standards, and the generally accepted accounting principles apply to the US banks. The off-balance-sheet issue is always difficult and significant, but I agree that it was more of an issue for the US than for the IFRS. When Deutsche Bank moved from using US GAAP to using IFRS in 2007, its balance sheet expanded by 40 per cent as a result. It is right to say that the issue of what was off balance sheet was much bigger for the US.

Gavin Brown: Much of this morning's discussion has been about looking back at what went wrong and why certain things were not spotted. You have responded to those questions, but I have a big concern. You have explained what auditors do and what they ought to be expected to do, but based on that it does not seem to me that they would spot the next Northern Rock, Dunfermline Building Society, HBOS or RBS now or in five or 10 years' time. Is that a fair assessment?

Iain Coke: There are probably a lot of lessons to be learned about how banks are regulated. The FSA has been considering those lessons. There may be questions about how accounting interacts with regulatory standards and about how some regulatory numbers fed into the capital rules, made them pro-cyclical, and therefore helped to inflate performance in the good times and caused it to become more severe in the downturns. The capital rules need to be looked at.

Ultimately, we have financial regulators to consider business models and look for the causes of potential business failures. It is generally accepted that auditors do 12-month going concern assessments, but problems at banks tend to happen quickly. Banking failures do not happen over a period of years. Rather, they happen over days or hours, and action needs to be taken to avoid the problems that we saw with the run on Northern Rock.

Richard Martin: I agree. I return to what I said earlier. An inherent limitation of financial reports, and therefore of audits, is that they are historical. It is a matter of trying to get a true and fair record of what has happened in order that investors can make their own judgments about how companies will perform in the future. Financial reports and audits are historical information that allows investors to make future estimations and predictions. Truth and fairness are needed on the balance sheet date, and that should be informed by events right up to the date on which the accounts are agreed by the directors and signed off by the auditors. Balance sheets should try to be records of conditions on the balance sheet date, and true and fair records of the period that led up to that date. To some extent, the business is not predictive; rather, it is a matter of providing historical information from which others will make predictions.

Gavin Brown: I accept that the data are historical, that there cannot be 100 per cent guarantees, and that events moved extremely quickly. However, things such as the loan to deposit ratios of certain banks did not happen overnight.

Iain Coke: A lot of information was known. The accounts provided a lot of information if people went through them. The accounting did its job to the extent that it provided information to the market, which was aware of many things and made its own judgments. It is quite difficult to hold auditors accountable for judgments that are made in the market.

David Wood: It was mentioned previously that the accounting standards are being improved in specific areas and there are extra disclosures of things such as risks and financial instruments. In essence, risks are flagged up to the outside world for regulators or shareholders to inquire about and act upon. The auditor's role is to ensure that there is transparency and that what the company says is true and fair.

Bruce Cartwright: Your concern is correct. If we were to say that there were no lessons to be learned from the past three years, that simply could not be true—it would mean that we all had sacks over our heads. What is needed is an understanding of the auditor's role and perhaps a redefining of part of it. However, that cannot be done in isolation; the regulator's role also needs to be looked at, as well as the question of what is the right loan debt capital. Your concern is genuine, but the body of regulation also needs to be considered.

Christopher Harvie: Does the name Friehling & Horowitz mean anything to you?

The Convener: It does not mean anything to me.

Bruce Cartwright: You have lost me.

Christopher Harvie: That is interesting, because they were the little guys in a downtown office in New York who were the auditors of Bernie Madoff. Two of them were there, one had retired and gone to Florida and there was a secretary, which means that there was a staff of three. Those guys audited the books of what was probably the biggest scam in world history—they were auditors.

Another point is that firms such as KPMG, BDO Stoy Hayward and PricewaterhouseCoopers went through the books of the people who invested money in the Madoff Ponzi scheme and did not go further into it. I am basing my comments on a piece in Time magazine that came out not long after Mr Madoff went into a police station and said that there was no possible innocent explanation of his business practices. Those are very big firms: three of the six biggest such companies in the world were not, it seems, practising any form of due diligence. We are looking at the minutiae of Scottish regulation, but when one looks, as we will do with the next panel, at the impact on the ratings agencies of the fact that many of the ratings agency classifications were based on AIG having underwritten the firms concerned, is there a question about whether the really big firms were themselves not up to the job—and that might be an innocent explanation?

Iain Coke: On the point about the small firm that audited the Madoff firms—again, my comments are based on reports rather than on detailed information—I understand that the people involved may not have been members of the American Institute of Certified Public Accountants and that they may not have had audit licences, so there are wider problems. It is difficult for us, as a professional body, to comment on action taken by someone who is not one of our members and who should not be doing the job anyway.

Christopher Harvie: But surely PricewaterhouseCoopers, KPMG and such firms would make such judgments.

Iain Coke: And they are subject to the US audit regulation, which was strengthened significantly after the Enron problems. I was referring to the specific small firm that was mentioned.

Richard Martin: Clearly, if there are audit failures, the people responsible must be held accountable for what they have done and the accountancy profession as a whole has to examine its role in the monitoring that we do and the disciplinary action that we take over our members.

Christopher Harvie: With respect, you had the Arthur Andersen failure as a result of the Enron fraud three years before this and yet the same thing has happened again—this time, even less of a real firm was involved. The dominance of the big firms went on: they signed off accounts and people believed them. As Lady Bracknell might have said, “To allow this to happen once is an accident, but to allow it to happen twice seems like carelessness.”

Bruce Cartwright: You have to distinguish between the roles, because the failure was of the auditor to the small firm. Until about two weeks ago, I was involved with the Globespan airlines. I was being told categorically, “We hold £35 million of your money.” We proved it only by going to the High Court. It is difficult, but to this day a certain individual would probably tell me that he still holds that money. You have to distinguish between the entity that is being audited where the fraud is being committed and the auditors of other entities that interact with it through normal business.

Christopher Harvie: Such cases have been happening on a large scale. You mentioned Globespan and what emerged in that case. Perhaps there should be some public involvement—a state notariat or something like that—to deal with such large-scale failures. One has the notion that very large concerns have a replica of the state in their structure and are fully alive to the long-term consequences of their actions, but that is not always the case. Firms can enter into the dangerous position of moral hazard—a phrase of John Kay comes to mind, “Too big to fail; too dumb to live.”

Iain Coke: Over the past few years, there has been a lot of focus on audit quality. That is important. When Patricia Hewitt was Secretary of State for Trade and Industry, she asked us to set up the audit quality forum to improve dialogue with investors, regulators, auditors and preparers on what people want from auditors and to look at issues including independence and processes around audit.

There has been a lot of investment in regulatory structures. As I mentioned, the audit inspection unit that sits under the Financial Reporting Council now undertakes independent monitoring of the performance of listed company audits and public interest audits. We also have the accountancy and actuarial discipline board. The range of penalties for poor performance by auditors and accountants goes up to suspension or withdrawal of audit licences from firms and individuals—a penalty that would, in effect, close down a major audit firm. We have independent processes in place to monitor weaknesses in the audit market and to take action, where needed. We have also made investment in looking more proactively at quality improvement.

Christopher Harvie: About five months ago, I was at a conference on the crash that was organised by the Commonwealth Parliamentary Association in—where else?—Guernsey. One interesting speaker was Dr Tom Burns, who is a lecturer in finance law at the University of Aberdeen. He spoke about shadow banking, and said that he intended to offer a course on the law of securitisation—that whole area of collateralised debt obligations. From his talk, I discovered that everything was carried on computer; no one had ever researched the law on securitisation. Given that something like audit is very closely interlinked with the existence of legal codes, does it not seem that what Burns found is very worrying indeed?

12:15

Iain Coke: A couple of weeks ago, we had a conference that was attended by Lord Turner. Among the other speakers was Josef Ackermann, who is the Deutsche Bank chief executive officer. One of his opening comments—it may have been a throwaway comment—was that one of the results of the Wall Street crash was the invention of securities regulation. It was thought that one of the results of the recent crisis might be the introduction of securitisation regulation. You make an interesting point.

Marilyn Livingstone: I think that David Wood said that there have been changes in the regulation of accountancy and auditing since the financial crisis—is that correct?

David Wood: It may have been Iain Coke, but yes.

Marilyn Livingstone: What changes have been made and have they gone far enough? On transparency, I ask basically the same question. You have talked a bit about transparency, and the committee has had questions about the transparency of the auditing process. I would like your views on any changes that have been made in regulation and on the transparency of the auditing process.

David Wood: On the transparency of the audit process, the FRC is looking at the audit report and whether it can be made more useful. That is one initiative. On increasing the transparency of financial statements, we mentioned the work that is being done to develop accounting standards and improve disclosures on financial instruments and risk et cetera. Changes in the corporate governance code are bringing in disclosures on business models and risk, and there are additional structural changes regarding risk with the recommendation that risk management committees be established at the highest level. A stewardship code has also been issued in relation to investors getting more involved with companies, which links back to the previous evidence session. A number of changes have been made.

Iain Coke: A couple of weeks ago, the FRC and the ICAEW launched a code of governance for audit firms. That project started in about 2007, so it is not directly related to the crisis. However, it addresses the competition and choice debate in audit firms and looks for ways to strengthen governance in audit firms and avoid risks, or perceived risks, arising from the withdrawal of another major audit firm from the market.

Richard Martin: I agree with all the foregoing comments. A number of people who are responsible for regulation in the area have been going over the lessons that have been learned and the things that need to be put right. The International Accounting Standards Board and the International Auditing and Assurance Standards Board have also been active. A lot of the work has been co-ordinated, ultimately, through the G20 meetings, and a lot of the direction has come from there. Because the International Accounting Standards Board is involved, a lot of the basic regulatory framework rests at a global level. The G20 has been very important in that process.

The International Accounting Standards Board issued a new standard as part of a new international financial reporting standard to deal with financial instruments—IFRS 9. We await action at a European level that will make that standard available for use in Europe. There is an endorsement process to be gone through at the European level, but that has not yet happened. Any help from you in encouraging the European Union to move on that would be helpful.

Marilyn Livingstone: What recommendations should we make to Government in our inquiry report to ensure that such a crisis does not happen again or, if one is coming down the line, that we know that that is the case? Are the changes that are being made enough, or should they go further?

David Wood: We need more thoughtful regulation. These days, there is a danger of making things overly scientific, putting numbers to risks and then relaxing because we think that the issue is sorted. What we need is better behaviour and more thoughtful challenge by non-executive directors. More thoughtful analysis of the risks is required.

Iain Coke: The challenge for regulators is that we are not likely to see the same crisis happening again. There will be another crisis—we do not know what it will be—and whatever we do now will not prevent it. We will never know how many other potential problems and crises have been prevented by the effect of regulation.

As regards what can be done in the longer term, financial skills were mentioned in the session with the previous panel. We think that financial capability is a bit of a problem across the UK, so we have a programme that involves working with schools to build up financial capability. We have started trialling it in England and are looking to expand it. It is a volunteer scheme. That was an area of interest in the previous session and we would be happy to provide you with more information on what we are doing, which could be considered in Scotland.

Marilyn Livingstone: That would be helpful.

Stuart McMillan: I have three very brief questions, one of which is for Mr Wood. It relates to his organisation's submission of September, paragraph 22 of which states:

> "in the short term, Scotland's reputation for prudence and careful stewardship has been dented."

Where is Scotland's reputation now, a few months down the line?

David Wood: I think that that is more of a short-term blip and that there are no long-term implications for Scotland's reputation. We have been concerned about our international reputation, but other countries have had their own problems to deal with. The fact that the two banks whose names are attached to Scotland have had problems was an issue, but I think that we will get over it very quickly.

Bruce Cartwright: That must be right. As we sit here in Edinburgh, we feel the denting of our reputation—it is tangible. We are all Scottish and it feels very personal, but we probably feel it worse. In London or in countries abroad, people have their own issues.

Iain Coke: As a Scot who lives in London, I tend to agree that such feelings may be felt more in Scotland and by Scots, but the problems were global.

Richard Martin: I agree.

Stuart McMillan: My second question is for Mr Coke and it relates to paragraph 24 of his organisation's submission, which mentions

"the need for cross border engagement over Financial Services regulation".

The issue was touched on in the session with the first panel. Do you want to add to what you said in your submission?

Iain Coke: We support the idea of more co-operation. The markets operate on a cross-border basis. Starting to regulate on a national basis would present challenges. Differences in regulation can create problems and undermine the effectiveness of regulation in all jurisdictions. We think that there needs to be cross-border regulation, but we are not in favour of the move towards the creation of European regulators because that would lead to a loss of political accountability and would mean that we might have problems with knowledge of local markets, products and cultures. We think that co-operation is needed, but we are not looking to single European regulation.

Stuart McMillan: If there was some element of European regulation, that would provide a standard, high level of regulation across the whole of the EU, and the member states within the EU could add to that. Would that not be a worthwhile thing to consider?

Iain Coke: We have that already, through the director process and regulation. The EU has its financial services action plan, which has worked over a number of years. We have regulation at that level, and we have co-ordinating bodies that are being strengthened. We support those moves. At an international level, the board of the Basel committee on financial stability is looking to co-operate internationally and develop common rules. However, we think that there still needs to be accountability at a national level as well.

Richard Martin: The European level is a difficult issue. We have to live with that because the EU exists, and it has produced some legislation at that level. Ultimately, however, one of the things that has been clear in this area over the past few years is the global nature of the crisis. To some extent, global co-ordination for the solution is necessary. Iain Coke mentioned a number of global bodies, and co-ordination must be achieved at that level.

The question of the level at which the regulators should sit is interesting. The solution has been to leave it at the member state level, to take account of various cultural and legal factors. The regulator has to be backed up by the law, and I do not think that, at the moment, there is a European law on which we could hang the post of European regulator, whether it were to regulate banks, stock markets or whatever. We would have to resolve that issue before we created such a post.

Bruce Cartwright: Iain Coke made the point that something will arise in the future that we cannot predict at the moment. We should think about what lessons we can learn from what has happened. A serious recommendation is that big financial services organisations should have living wills; I know that that issue is being pursued. In the case of Lehman Brothers, operational control was transferred over the course of a weekend—on a Sunday night, basically. In such a situation, there will inevitably be a lot of collateral damage. If an institution fails in some manner—we might not see anything on the scale of the Lehman Brothers collapse, but smaller institutions will still fail—living wills would help to limit the resultant collateral damage.

Stuart McMillan: Paragraph 11 of Mr Martin's submission talks about the Scottish Government influencing how regulation can be applied in the sector. The Scottish Government cannot introduce any regulation, as that comes from London, although it can certainly discuss matters with stakeholders and interested bodies. However, if it wanted to feed something back to London, but London did not want to accept that—regardless of which parties were in power—that would leave the Scottish Government with little influence in terms of trying to improve the situation or to liaise with the industry in Scotland.

12:30

Richard Martin: We were talking about a lot of background matters that the Scottish Government should address in trying to help the development of the financial services sector in Scotland. Some of those matters, such as education and encouraging businesses to locate here, were alluded to earlier. It would surely be worth while for the Scottish Government to express its views to Westminster and at the European level, and to make it known that it is closely examining the regulatory solutions. We have not by any means come through that process yet; I do not believe that we have responded properly to the crisis in terms of bank regulation, nor in terms of corporate governance. There is plenty to play for: Scotland needs to communicate to the Parliament the importance of those issues, and you need to communicate that you are seeking the right type of solutions through that process.

David Wood: I have a suggestion. We have discussed regulation, but I believe that we need to move towards having better and more effective, rather than just more, regulation. The danger of approaching an issue by saying, "Nothing like this must ever happen again" is that we often end up putting in place huge and burdensome regulation that stifles a lot of economic activity. We need to be careful and guard against that—there is a balance to be struck.

The Convener: I have a question on the independence of the audit process, which Iain Coke mentioned in his earlier responses. It is known that the auditors of large companies and institutions in particular often carry out significant work for those companies in addition to the formal audit process. The value of the additional work is often significantly more than the value of the formal audit. Does that relationship undermine the independence of the audit process?

David Wood: I will take that question—I referred earlier to the project that ICAS undertook on non-audit services. In 2001-02, the non-audit services fees for the FTSE-100 companies came to around 300 or 400 per cent of—three or four times—the audit fee. A lot of changes have been made since Enron; there was a lot of scrutiny around the issue at that time. Non-audit fees now comprise roughly between 30 and 70 per cent of the audit fee, depending on how that is analysed. The issue has reduced significantly in size, but there are still potential issues around non-audit services influencing the auditor.

We take a principles-based approach to the matter. Although some non-audit services are still allowed, strong principles must be followed so that certain things are not allowed to influence the auditor; there is a framework around that.

Our project on non-audit services involved a working party that consisted of a great cross-section of different stakeholders with an interest in the issue. We conducted a comprehensive survey of finance directors, audit committees in companies and investors on the question of whether non-audit services should be completely prohibited, which was a suggestion that arose from John McFall's Treasury Committee in London.

There was no appetite for complete prohibition. Everybody whom we spoke to and those who responded to the survey felt that non-audit services had been restricted so much in the past few years that we are now at the right sort of pitch. It is difficult to draw a black line, because the auditor is required to provide—or it makes sense for the auditor to provide—a number of services in addition to the audit. It is not easy to put in place a clear dividing line.

Bruce Cartwright: I think that that gives you one of the answers, David. The term "non-audit services" can be quite broad, but if you get the disclosure right in relation to what those services are, the audit committees and the shareholders can make an informed decision. It is wrong to lump everything under one heading and say that the fees come to a certain amount. People have to understand what is being done, and then everyone can take an informed view on how appropriate it is.

David Wood: One important aspect is that since Enron, audit committees in companies have taken on the role of deciding whether auditors should take on non-audit services, and they oversee any independence issues that arise.

Iain Coke: After the Treasury Committee report was published last year, I did some research into the disclosures of auditor fees in the accounts of the 23 largest UK financial institutions. That research supported the analysis that David Wood has given. Overall, an average of 56 or 57 per cent of the total fees charged by the auditor was for audit, but behind that we gave quite a precise meaning to the term "audit". It covered only the work that was done for the year-end financial statements and did not include work such as reviewing the interim financial statement—that is described as a non-audit service.

A layman would describe many of the non-audit services as audit. They involve assurance work, perhaps related to the interim financial statements, compliance with Sarbanes-Oxley, other financial information or the controls around the financial reporting framework. Auditors are allowed by statute to do that work, and it all comes under the term "non-audit services". The Companies Act 2006 provides for how things must be disclosed, and we think that the disclosures might be misleading to the layman, who does not necessarily understand what the additional services are.

In my research, I looked at just the biggest institutions, but the figure was that 78.5 per cent of all the auditors' remuneration seemed to be for audit and audit-related work. I was not able to identify what was assurance work and what was a pure non-audit service, but in that context the true non-audit fees seem a lot lower than some of the figures that have been quoted.

The Convener: To guarantee the independence of the audit process in a large institution, would it not be better if the auditors were appointed by a third party such as the FSA rather than by the board of the company?

Iain Coke: Auditors are appointed by the audit committees, so the independent non-executive directors are responsible for that and shareholders have rights of approval. In the case of banks and financial institutions, the FSA has the ability to say that it does not think that the auditors are up to the job. The FSA does not appoint the auditors, but I understand that it has a right of refusal, if you like.

Richard Martin: That makes sense. We heard about the auditors of the Madoff company that should not have been allowed to do that work. The regulator in the States has a list of approved firms that it allows to carry out audits.

The Convener: I am sorry that it has been another lengthy session, but we had a lot of ground to cover. I thank David Wood, Bruce Cartwright, Richard Martin and Iain Coke for their evidence.

12:38

Meeting suspended.

12:43

On resuming—

The Convener: Colleagues, we welcome our third panel this morning. Again, I apologise that we are a little behind schedule, but we have had a very interesting morning so far. I welcome Richard Hunter from Fitch Ratings, which is one of the leading global credit rating agencies. Perhaps he can make some opening remarks before we open things up to questions.

Richard J Hunter (Fitch Ratings): I will start with just a few words on credit ratings and Fitch, but I shall move as quickly as possible to questions as I sense that there are quite a few questions today.

My job at Fitch is to head up the corporate ratings practice for Europe and Asia. Within Fitch, which is one of the three global credit rating agencies, we provide credit ratings on literally tens of thousands of institutions and issuers, including Governments, corporations, banks, insurance companies and all sorts of other issuers of finance instruments. We have dual headquarters in London and New York and we have about 2,000 staff in around 50 offices.

The credit ratings that we provide are forward-looking opinions on relative vulnerability. They take a huge number of factors—economic, operational and financial—that can affect the creditworthiness of an issuer or a bond and they reduce that view into a single three-letter scale. The beauty of the scale is its concision. It takes all that potential information and truncates it into a single three-letter scale. The curse of the ratings scale is also its simplicity. It involves an enormous amount of information entropy. Obviously, it is a single data point that does not contain multiple scenarios in its signal as a rating symbol.

12:45

Against the limited number of rating notches that we and the other agencies have, investors have literally thousands of basis points—that is, hundredths of 1 per cent—to distinguish the risks that they see in anything from a Government bond that is trading below the London interbank offered rate to a distressed company bond that is trading at 20p on the pound. Obviously, in their decision, investors reflect on many other risks in addition to the default risk that is specifically targeted in our ratings.

Obviously, reducing the complexity of all those factors into a single three-letter opinion is a huge challenge. We are very aware of the burden upon us to give as much thought to that rating as we can and to ensure that the opinion and all the limitations around it are communicated as clearly as possible. At the same time, the users of the ratings from all walks—that includes regulators as well as investors and issuers—also have a burden of understanding the limitations of the ratings that they choose to use and of using them with due care to the fact that they are not an audit or guarantee or specific percentage prediction. Our ratings are just one opinion to be weighed up in an investor’s investment decisions and, indeed, in a regulator’s prudential decisions.

I could discuss other things about our record and the forthcoming European regulations, but I sense that our time is probably best used if we move straight to questions.

The Convener: Thank you very much for those opening remarks.

The role of the credit rating agencies has become much better known—or at least more talked about—in recent months following the financial crisis. In your view, were the ratings that are issued by rating agencies perhaps misunderstood by some of those who use them? You indicated that there is a limit to the information that such ratings provide. Were they perhaps used as if they provided more than they did?

Richard Hunter: I would hate to start my first answer by larding it with caveats that there are so many limitations to the ratings that people misuse them. Clearly, the performance of a number of ratings, particularly in structured finance, has not met our expectations, and we are working hard on that. Nonetheless, I agree that there has been a problem with people not so much misusing as misunderstanding ratings. There is a limit to the dimensions of risk that ratings represent. For example, a rating does not capture the liquidity risk of a bond. A bond might be very unlikely to default but simply be illiquid because it is denominated only in very large selling amounts for a very small bond from an issuer that nobody has heard of. The rating does not speak to liquidity or to many other things.

The other issue that has become apparent is the regulatory usage of ratings. As an industry, we—Fitch and the other two agencies—have not advocated the use of ratings in regulations. At times, we have actually fought against the use of ratings in regulation because, although ratings are a very useful shorthand as a three-letter symbol, they clearly cannot capture all risks. There have been misunderstandings. Clearly, on our part, areas of the rating portfolio have not met our expectations—we do not understate that—but there has been an issue about misunderstanding of what the rating symbols mean.

The Convener:

The Convener: You mentioned how your business operates. Could you also give an indication of the types of services that you offer and who your client groups are?

Richard Hunter: Essentially, the business model of a rating agency is that we are typically paid from two sources: the people who subscribe to the ratings and the people who are rated. For the large rating agencies, the bulk of the rating revenues comes from the people we rate. Similar to auditors, we have in effect an issuer-pays model. The fee that we get paid depends very much on the size of a bond issuance, but there is a cap. Typically, the highest amount of money that we can receive from a single issuer is limited by a cap on fees for any individual issuer or, indeed, individual issuance.

Do you want any more detail beyond that?

The Convener: I will pass on to Rob Gibson, who will ask the next question.

Rob Gibson: Could you, for the benefit of a layperson, elaborate on the rating models, methodologies, assumptions, criteria and protocols that you employ?

Richard Hunter: That is quite a big question, because we are talking about criteria and protocols, so I will separate it into the way in which we get to a rating decision, and the analytical judgments that go into that and how we view things.

I will start with the protocols. If we were going to rate a bank, we would send two analysts to visit the bank, having previously reviewed its financial statements, press commentary on the bank, market data, how the bank's securities trade and how it is viewed by the marketplace. They would have reviewed it against a peer group of all the other banks that we rate. They would have compiled a questionnaire and sent it to the bank and they would, typically, meet someone such as the chief financial officer or the treasurer of the bank. They would then have a rating meeting in which they would go through the questionnaire with the bank and discuss topics that they found of interest or relevance to the rating analysis. That would typically happen, on average, once a year. If it were a busy year for the bank, with a lot of activity, the contact might be more frequent, but typically it would not be less frequent than once a year.

In the course of the following 12 months, the analysts would go back and meet in a committee consisting of a minimum of three and typically five or six other analysts. There is a minimum seniority for the people on committees. The committee would vote and determine a rating, which would then be published, typically within 24 hours. The issuer would be able to provide new information if it wished to appeal the rating decision, although that is not a right. We often get comments back from issuers to the effect that they are unhappy with the rating decision, but they do not have any new information. Ultimately, it is an opinion rather than a fact set.

The rating would be published—typically on wire services such as Bloomberg and Reuters—and it would then be surveilled. The analysts in charge of the rating—bear in mind that our analysts are tasked with looking after only 10 to 15 issuers on the corporate and the bank side and on the Government side as well—would be responsible for surveilling it, which means that they would check every morning on the Bloomberg screen whether anything had happened to the company, keep abreast of the news, periodically review the financial statements and review their own projections for the company. If anything changed, it would be their responsibility to convene a committee. They are typically supervised by a team head and their team head will, in turn, have a team head who supervises them.

In addition, we have an internal team called the credit policy group, which is outside the rating teams but is made up of experienced analysts who review the portfolio and consider whether this or that rating looks out of line and whether we have moved based on the news flow. That is, succinctly, more or less how the rating process works.

I will now address how the methodologies work. Typically, analysts in the analytical teams are tasked with writing down and developing our criteria. Criteria for an asset class as long standing as banks—we have been rating banks for more than 20 years—have obviously been written down for some time. The criteria are periodically revised; you will not be surprised to hear that they were very heavily revised at the start of the year.

Criteria are developed for new asset classes and those are published and put out on our public website, so people get a chance to see them. The criteria are also subject to a voting process. We have criteria committees that include people from that asset class and people from elsewhere. For example, bank criteria would be reviewed by bank analysts but also by corporate analysts, Government analysts and analysts from our structured finance team to see whether they stand up to scrutiny from outside the immediate asset class.

The important point is that all these criteria are freely available. I do not mean that you have to be a subscriber and pay us a subscription fee for them to be freely available; you can go to the website this afternoon, subscribe and get every single criterion that we publish for free. They are up there on a continuous basis, which means that anyone who is using our ratings can look into the criteria, see how we got to a specific rating and gain an insight into which way the rating might go over time.

Rob Gibson: You mentioned that, unsurprisingly, the process has been tightened up this year. How do the procedures and methodologies for credit risk characteristics for structured finance products differ from those for other securities?

Richard Hunter: I will again split that question into two: how we deal with it and whether the risks are different.

The way in which we deal with it is largely similar to the one that I described. Analysts are responsible for writing down criteria, explaining the criteria to a panel of their peers and getting a consensus among their peers that the criteria that we have used are sensible and plausible as a way of determining a rating for an instrument.

There are many differences in the structured finance instruments. They are largely synthetically created. Whereas a paper company exists to make paper and might have to get a rating as an ancillary obligation in getting its bonds into the bond market, the special purpose vehicle in structured finance exists and is designed simply to access the capital market, so the rating is a more important part of the process.

A broader range of risk is associated with structured finance, largely centred on systemic risk. Let me take the question at a plastic level again. If we rated the large telecom companies in Europe—BT, Deutsche Telekom and so on—we could rate them all as BBB. Indeed, many of them are in the BBB category, which is one of the low investment grade categories. It is very unlikely that all the major telecom companies in Europe would experience a default at the same time, but the likelihood of their defaulting could be equally BBB. It would be BBB for different, idiosyncratic reasons, but they could be assigned the same category of rating.

On the structured side, in which one might, for example, parcel up mortgages and put them into a security, it is much more likely that 10 of those securities could fall over at the same time. Independently, they might each have a default likelihood of BBB, but the likelihood of them all falling down together is much higher, as there is much more systemic risk in structured finance than there is in corporate finance.

If we consider the rating performance, that point becomes evident. We have seen that rating upgrades, downgrades and defaults for corporates tend to be spaced out over time. They can cluster somewhat, but there is rarely a year in which there are no defaults. Conversely, structured finance had a long period of 15 to 20 years in which there were zero defaults in some areas, such as commercial real estate, and then lots of defaults arrived at the same time. That is because structured finance vehicles are more exposed to systemic risk than to idiosyncratic risk, which a corporate is exposed to.

There are lots of reasons for that. You will understand the example of mortgage securities, because they draw largely from the same pools of mortgages that have been sent on to the banks. Another reason is simply that a corporate entity can respond to a crisis: a paper company could employ various cost-cutting measures—such as closing a factory—raise equity or go to the bank for emergency funding. In essence, however, a structured finance vehicle is a closed box once it is completed. That insulates it from a management who decide to make a big, expensive acquisition, so it does not have that downside risk, but it does not have the upside risk of the ability to respond if something goes wrong in the economy.

Rob Gibson: We have concerns because the complexity of financial products almost mirrors the development of the rating agencies. They have developed and become a major issue in the past 10 to 15 years. I suppose that this is the biggest crisis for CDOs, and the way in which they develop in future must affect how you can assess them. You have given two excellent examples, but the underlying problem seems to be that the management and directors of banks could not understand the products. How do rating agencies issue a rating on a structured finance product that reflects the characteristics of the assets that underlie it?

Richard Hunter: The word "complexity" is used a lot, but it is important to go a little beyond the topic of complexity. There are lots of moving parts, and many people cite the fact that the documentation for a structured finance deal might be 2,000 pages long. The figure of 2,000 pages is largely apocryphal—typically, it is a few hundred pages—but the documents are still a lengthy and dense read.

Ultimately, it is possible to identify, in a relatively finite list, the types of risks that structured finance vehicles and an issuance are exposed to. There is a difference between complexity and the ability to put an estimate on the risk. For example, everybody understood that a residential mortgage security would be exposed to the frequency with which residential mortgages default. Equally, if I asked you what the odds are of every single mortgage holder in the United Kingdom defaulting at the same time, you would say that they are astronomically low and not something that you would consider in a AAA scenario. Then I would ask what the likelihood is of half or a quarter of them defaulting at the same time and you getting none of your money back on the houses.

13:00

Those are not necessarily complex questions; they are issues on which people have to make an estimate, and people's estimates were off. It is now clear that our estimates of the likely default and foreclosure rates were wildly under the actual experience. That was the case for US residential mortgages for a variety of reasons, including, but not especially, fraud. The track record of the agencies and the market in Europe was much stronger. In talking of complexity, it is important to understand that a more finite list of risks is attached to the average structured finance transaction. There were some esoteric, needlessly complex ones, but the list of risks is reasonably finite. The issue to be understood is more to do with how the risks interact with one another.

Let us take the example of a CDO. The senior manager in a bank thinks that the CDO is full of corporate underlying—bonds that oil companies and so on issue—but it is actually full of residential mortgages that have been put into it as a different type of CDO. The bank therefore has both residential and commercial mortgage exposure, the latter of which is made up of a lot of small, commercial real estate—high street shops and so forth. The risk manager has a lot of residential risk across three different pots but has not joined the dots between them. The complexity is more to do with joining the dots and making the correlations than with looking at an individual instrument.

Rob Gibson: There has been some criticism that ratings are not reviewed often enough. Are there ways in which the surveillance of ratings ought to be made available to the public, in addition to the data that you publish on the web?

Richard Hunter: That is a good topic, which is more for Europe than for the United States where, if someone invests in a securitised bond, the underlying data are reasonably easily available. There are varying schools of thought on how easily available that stuff is in Europe, but my conclusion is that it is not as easily available as it is in the United States. In Europe, the ability of investors to access directly the information in forming a view on the underlyings is improving. The banking industry has realised that it will not get this product off the ground again until it re-establishes confidence in it.

Something that is almost more important than making available the data to users is the format and time that investors are permitted to review the information. For example, if someone buys a mortgage-backed security that has our rating on it and they want to know what our rating is, we have enhanced our website so that they can download a model that allows them to change estimates. If an investor thinks that 30 per cent of people will default, they can change the estimate to 30 per cent and see the effect on our credit rating. That is marvellously user friendly, but the fact of the matter is that, at the peak of the market, investors simply would not have had time to review the documentation or data. Also, if they were buying on the secondary market, they would not have had time to review the surveillance data. In a typical scenario, someone would have got a phone call around 10 am asking them whether they would like to buy part of the 2006-1 tranche A product, and they would have been given until 2 pm to decide whether they were in. At the peak of the market, the time that banks and asset managers had for due diligence was extremely truncated.

Making the data available is one thing. Given the various forums that the banking industry has set up, there is reason to believe that availability will improve. However, we cannot do that: we do not own the data on the underlyings; the originators and banks are responsible for that. The committee also has to bear in mind that swamping people with data does not necessarily get better answers for them. If we look at the US residential mortgage market, the unfortunate surprises occurred not for want of data but for want of interpretation of data.

Rob Gibson: Are rating agencies subject to any requirement to report the number of rating actions that they take in each class of rating?

Richard Hunter: We are now, as a result of forthcoming regulations. I think that you would find that, in the past, the three global agencies did that, but it was perhaps not as evident as it is now. Over the past year and a half, work has been done to synthesise all of that.

In the past, someone could find out what had happened to an individual bond that they held. The published commentary now says, "All this particular type of asset class has been affected. Of all these types of bonds, X per cent have been downgraded and X per cent are on negative outlook." That is new. We have just introduced outlooks on our structured finance bonds to make them slightly more forward looking and to help that commentary.

We are required to make that information publicly available, which is central to the business model of the rating agencies. All the information on our ratings is available to the public—it is out there for anybody to see. There is no selective disclosure, so there would not be a situation in which one investor gets the information while another does not. It is reasonably important to bear in mind that information asymmetry has been a common theme in the credit crisis.

Marilyn Livingstone: I will go back to what Richard Hunter said about credit ratings and residential property values. One of the big criticisms of credit rating agencies has been that they have failed to take into account macroeconomic factors such as residential property values. Do you accept that that is a fair criticism?

Richard Hunter: I accept that our estimates on residential mortgage foreclosures, particularly in the US, were off. To give some hope to the situation, we have understood where they were off. We did—in the stress cases for our AAA ratings, for example—assume very substantial fall-offs in residential values. There is perhaps a misperception that we assumed that house prices would keep climbing, and that we were blithely unaware that there was a cycle in the housing market.

There was a failure in making the link. For example, a AAA stress case in California assumed that house prices there would drop by 70 per cent—a level that they have not reached, even at this stage. The gap—the failure to make the link—was in assuming a stronger link between declining house prices and the willingness of people to walk away from a house.

People in this country may not appreciate this particularly well but, in the United States, if you have a mortgage on a house and you walk away from it, particularly if it is a second house, you are done; you hand the keys back, and that is it. You do not get pursued through the debtors court. The bank ultimately takes possession of the house, but you no longer have any obligation. You have handed the house back, and you are finished with it.

That means that there is a greater propensity for people just to walk away from their house, particularly if it is a second house that they have bought as an investment. Their equity is gone, so there is no point in servicing a loan on the house that will not have any equity value in it for perhaps 10 or 15 years. We have learned a lot from that.

During the crisis we also learned much more about the checks on people. I do not blame the people who were taking out the mortgages, because they were encouraged by an unregulated mortgage lending sector to take out mortgages for which there were limited checks—and, in some cases, falsified checks—on people's income levels. That contributed significantly to the scale of the housing decline and the foreclosure rates.

As a follow-up, I can send the committee detailed information on the various adjustments that we have made to our residential mortgage security models. I assure you that the stresses in those are now much harsher. The broader question of whether there was enough macroeconomic discussion is another area that we have rectified. We have a highly thought of sovereign rating team, but we were not using it enough. The team now sits in regular cross-group meetings with our structured finance team. I will have a meeting on Friday, when I get back, with all my senior managers. Our chief economist also comes to the meetings and goes through all our economic data.

It is not just about listening to what the economists are saying on where they think that GDP is going, and where the stresses are going, but about hearing, from the ground up, where corporates are going. At present, for example, there is a big gap in terms of market expectations between what our credit ratings say about corporates, which is that there is fairly weak growth, and the fairly strong recoveries in the equity markets. If our sovereign guys were not talking to us, they might be reading different signals on corporate health and we would not know.

Marilyn Livingstone: Do you believe that lessons have been learned?

Richard Hunter: Lessons have been learned. As one of the previous witnesses from the accounting profession said, none of the lessons that we learn will bullet proof our ratings against future defaults or future negative rating migration. However, we think that the lessons that we can learn in this instance have been learned.

Marilyn Livingstone: The Treasury Committee commented in its ninth report of 2009 that

"markets appear to have used credit ratings for more than they were designed to do".

Do you concur with that?

Richard Hunter: Yes. In fact, I can give you an example of that, although my understanding of it could at best be described as a layman's understanding, as it is on the structured side of the house. A single-tranche synthetic CDO, which does not really exist in the marketplace anymore, is an insurance policy against a particular event. Because the event's chances of occurring are very remote, the CDO could be rated AAA. All the same, it is by no means a liquid instrument; no one will buy it off you, because it is basically a bilateral swap contract drawn up between two counterparties.

However, a public sector entity such as a local authority, a school district or whatever might be required to buy only AAA-rated instruments because of the implication not just that they will not default before the thing is cashed in—in other words, it is likely that you will get your money back in a traditional credit sense—but that the investment itself is liquid and, like a UK Government security, which is also rated AAA and is indeed very liquid, could be sold to almost anyone at any time. The first assumption was accurate; however, with regard to the second, liquidity was being imputed to credit ratings in a way that did not figure in our rating discussion. Instead, the people who drew up the guidelines were basing assumptions on the long history of what typically gets rated AAA. In the past, what typically got rated AAA were Government securities or extremely large corporates that had a very deep bond market associated with them.

Gavin Brown: How many people work for your organisation?

Richard Hunter: Two thousand.

Gavin Brown: How many of them are analysts who decide the ratings?

Richard Hunter: Slightly more than half.

Gavin Brown: You said that you rate literally tens of thousands of products, some of which are hundreds of pages long. Given the number and length of these products and the number of analysts involved, how accurate can you be in rating something AAA, AA or whatever?

Richard Hunter: That is a very good question. Those tens of thousands of products can be broken down by complexity. A more complex product, for example, will require more analysts. When the US Securities and Exchange Commission carried out an investigation, it discovered that our agency was the only one to keep pace with the growth in the number of these securities and to ensure that more analysts worked on them. I said that, at the moment, we have about 1,000 analysts, but a year ago we had 1,500. A number of analysts left Fitch because the market for those securities does not really exist any more and we do not need people to read those 200-page prospectuses.

The question is this: what is the reasonable expectation of a 200-page document having something buried on, say, page 197? Under the current process, the investment bank that puts together the transaction gets a draft legal opinion that is designed to identify anything unusual or legally different in the transaction, and our analysts focus more on reviewing that legal opinion than on reading the document itself from page 1 to page 200.

At the same time, analysts will carry out a high-level review of the transaction documentation. Of course, that does not exclude the possibility that something unusual in the documentation will affect the rating somewhere down the line, but we—and the regulators with whom we have discussed the issue—are comfortable that the level of investigation that we are carrying out is reasonable.

With these securities, our rating actions are not driven by the fact that the documentation runs to 200 pages. It was not a particular level of complexity or some problematic hook on page 177 that caused the problem. What caused the problem was our forward-looking estimate of what would happen to the underlying asset class.

A number of transaction ratings have also been affected by counterparties that have experienced problems. Lehman Brothers, for example, used to provide liquidity to many transactions, but it simply disappeared overnight.

That has led to a large number of rating downgrades on transactions in which it was involved as a counterparty when it was seen as quite a healthy bank—it was seen as quite a healthy bank until recently. What has typically caused problems has not been something on page 177 of documentation that we would have found if we had had another 10 people to trawl through it; rather, more fundamental issues have caused the problems. That is why I try to emphasise that the complexity debate can be a red herring.

13:15

Gavin Brown: A debate that has been raised in public is that about the potential for a conflict of interest. You mentioned that the bulk of your revenue comes from organisations being rated. Can you give a rough percentage for that?

Richard Hunter: It is more than 80 per cent.

Gavin Brown: So organisations that are rated pay 80 per cent of your organisation's revenue. What measures do you take to minimise or prevent any conflicts of interest and ensure that those who get paid are not those who do the rating?

Richard Hunter: That is a very good question. Perhaps we could also discuss alternative business models.

When I said that Fitch has 2,000 people and that roughly half of them rate transactions, somebody might have wondered what the other half do. We have separated out the marketing function for some years now, but that has dramatically increased over the past few years. Nobody who works for me negotiates fees with any of the issuers; none of them is even allowed to discuss fees. I do not know what fees any of our issuers pay us, and I am not allowed to find that out. The business development process is completely separate. That requires quite an investment on our part, but it is clearly necessary to address the potential for conflicts of interest.

We have compliance auditors who go through a risk-based schedule for the departments. They check the files for issuers and for any evidence of conflicts of interest that are affecting any of the rating judgments or any of the criteria developments, and they report through a compliance officer, who now independently reports directly to a board.

We also have various other mechanisms. As I mentioned earlier, we have a credit policy group that consists of independent people outside the analytical line. They check what is happening with the ratings at the portfolio level. In addition, we have a chief credit officer function in each of the teams for looking at more local levels. I have a chief credit officer just for Europe and Asia corporates. They look at the portfolio and ask whether any unusual pattern is developing.

We have recognised for a long time that a conflict exists in the issuer pays model, so why do we choose it? Thirty years ago, there was much more emphasis on subscription revenues, but two things effectively killed that, one of which was the significant increase in capital market activity. It was not possible to generate sufficient subscriptions to employ 1,000 analysts to consider transactions and have enough people to avail them on a timely basis. The other thing was the invention of the photocopier. We hope that people behave themselves when they read the legal language at the bottom of our research and do not copy it or pass it on to friends, but we know that, even 30 years ago, that happened fairly swiftly.

What else can we do? Can we get away from an issuer pays model? To paraphrase Churchill, it might be the worst system, except for all the others. It is often said that investors would pay if we went to a subscription-based model. We should bear it in mind that investors are much more concentrated than our issuer base. We would have a very concentrated audience with the people who would be able to pay subscription fees and be able to support the size of operation that we and the other two agencies have.

I will give members an example. Last year, our agency was the first to start to move CDO ratings down quite significantly. The loudest and most pointed comments that we got back—there were pointed remarks on the potential impact on our economic future—were not from investment bankers or issuers, but from investors, because investors held the securities and did not want the ratings to be downgraded. We publish opinions on investments, and there is no party out there involved in the process that is neutral about its results. That is a brutal fact. Ultimately, every opinion that we publish will make somebody somewhere unhappy. It might make the company that we downgrade or the investor who holds a bond unhappy. If we upgrade something, it will make somebody who sold a bond short unhappy. There will always be somebody with a vested financial interest who will be unhappy.

We have found—and the statistics show—that this is the best system. There has not been a substantial economic demand for investor-supported systems and they have not prospered.

Gavin Brown: You mentioned a number of things that you have done to minimise or get rid of the conflict of interest, including separating analysts from marketing, appointing compliance auditors, establishing a credit policy group and having a chief credit officer in each of your teams. Have those things happened as a consequence of the financial crisis, or did you do them prior to the financial crisis?

Richard Hunter: Some were things that we did prior to the crisis, although efforts have been intensified in that region. We have significantly increased our investment on the compliance front, for example. We have created a new operational risk team that ensures that we can respond with procedural changes as soon as we identify any issues that need to be addressed.

Ultimately, the conflict of interest issue comes down to a question of culture. Is the culture in the company such that the compliance examiners will come back—as they do—with zero findings of conflict of interest? We are comfortable that, where our ratings have not performed according to our expectations, it has not been an issue of a conflict of interests driving a rating decision that was inappropriately derived; it has been simply that our forward-looking estimates of how the market would develop and how different factors would affect securities issuance have been significantly off.

Gavin Brown: Scotland on Sunday carried a story about the rating of UK Government bonds and used the quote that they were

"sitting on a bed of nitroglycerine".

Do you view that comment as an outlier, do you come in behind that comment or are you somewhere in between?

Richard Hunter: We would regard that comment as an outlier. The United Kingdom has a AAA rating from us, with a stable outlook. The UK has had to spend a lot of money as a result of the financial crisis. It has had to spend more, as a percentage of GDP, than some other countries—above 20 per cent of GDP has been the immediate cost of the financial crisis, including the loss in revenues through the shrinkage in GDP. However, the UK started the financial crisis with a lower than average level of debt in relation to GDP. Also, the amount of money that has been spent is a gross amount of money—a lot has been spent in buying securities. Ultimately, there will be some return on that, so the net cost will be lower.

The other thing that we look for in highly rated sovereigns is a track record of delivering on difficult policy decisions. Although it can often be difficult for people who are born and bred in the UK to see this in a global context, the UK has a reasonably good track record of responding well, at the policy level, to a need for fiscal consolidation. So the absolute levels of debt, for us, do not dramatically outlie the boundaries that we see for other AAA-rated countries. More important for us will be the trend that that indebtedness takes over the next five years.

Christopher Harvie: Let me take you back to the takeover of ABN AMRO in early 2007 by the Royal Bank of Scotland, Fortis and Santander. An article by Sam Jones, Gillian Tett and Paul J Davies in the Financial Times talks of a mispricing of constant proportion debt obligations. ABN AMRO had made a particular market in those and was offering returns that were substantially above those of traditional mortgage-backed securities. However, Moody's downgraded the rating of CPDOs in mid-2007 on discovering that there was a computer flaw that was overpricing them by up to four notches. In October 2007, the Royal Bank of Scotland found the money to bid what amounted, in the end, to €70 billion for ABN AMRO with the result that we all know—the biggest corporate loss in British financial history in 2008. What role do you think the failure of the credit ratings agency played in that? The FT seemed to be of the opinion that the word of the rating agencies had misled the markets on that.

Richard Hunter: There are a few topics in there. I will start with constant proportion debt obligations and say at the start that we did not rate them because we did not think that they would get to anything like a rating level of AAA; we thought that the highest they would get would be the middle of investment grade. I am conjecturing with hindsight, but I doubt whether they would have made a significant difference to RBS's interest in bidding on ABN AMRO. Obviously one of the most attractive things for RBS about ABN AMRO would have been LaSalle, the large regional bank in the US. Again, because I do not know the figures for the exposure of ABN AMRO to CPDOs, it is not clear to me whether it would have made a particularly big difference to RBS's decision to enter into that merger.

On the banks' use of ratings for their own securities and pricing, which was discussed earlier, a broader issue that has to be considered is what additional measures banks, regulators and other people need to put in place to look beyond an individual credit rating. CPDOs were an interesting case because, at a very simplistic level, it was almost the ultimate in credit rating arbitrages. A CPDO was an instrument that was theoretically designed to have minimal default risk but an extraordinarily high loss severity if there was a default. We did not believe the default story, so we did not get as far as looking at whether the enormous loss severity would cause us great problems. Some CPDO constructions involved a doubling up of losses; as things got worse, one would buy more into the credit default swap market.

As an example, that was a very clear rating arbitrage, and it comes back to transparency. We put all our criteria on our websites, which makes it possible for investors and investment bankers to understand where we are going. From that perspective, it is doubly important that regulators and other users of our ratings find additional tools. If one worked out an infinitesimally small default likelihood but a massive loss severity, the pricing of CPDOs made sense. However, loss severity is not expected for AAA security.

Christopher Harvie: I had a sort of forewarning of this because one of my economics students in Tübingen pointed out that an American financier called Paul Erdman, who was jailed in Basel, produced what was called a finance thriller in 1994 called "Zero Coupon". It argued that for the financial hood the thing to do was to move out of stocks and into rating agencies because they were much less supervised than under the SEC. It was curious to see that looming up in the Tett article.

I believe that the structured investment vehicle market was largely concentrated in London at that stage; is that true?

Richard Hunter: A lot of SIVs were based on this side of the Atlantic. Again, it is difficult for us to comment because we did not rate very many SIVs.

To go back to your comment about the degree of regulation of rating agencies making them a suitable target for someone to move into from investing in stocks—that would be a fairly far-fetched plot for a novel. It was not an absence of regulatory supervision of rating agencies that led to the rating performances that we have seen, which again have not really met our expectations.

Increased supervision is on its way and, just as a flavour of it, a European Union regulation is being enacted at the moment that will prohibit us from publishing ratings at all if we do a bad job. Forget any discussion of free speech—we will not be able to publish ratings if the regulators determine that our behaviour is in any way inappropriate and that our licence should be withdrawn. I would not say that the topic of additional regulation for rating agencies becomes redundant, but the European scheme that has been put in place certainly represents as much regulation as would seem to be tolerable and make sense for the industry. More important will be that that approach is adopted internationally as much as possible and that there is a harmonised approach so that we do not have an obligation to do one thing in the United States, the exact opposite in Europe and a third, completely different thing in Japan or Australia.

13:30

Christopher Harvie: So you would absolve Moody's of responsibility for, let us say, the irrational exuberance of Sir Fred Goodwin.

Richard Hunter: I would not want to speak for my colleagues in other agencies. It would be very unusual to draw a direct line between a rating agency's decision and the actions of a corporation's executive.

Lewis Macdonald: I understand that Fitch upgraded the Royal Bank of Scotland's rating in December. I believe that it is now AA- for long-term default prospects. It would be helpful if you can confirm that. If not, I would still be interested in hearing your comments on the wider question. When you consider the rating of an institution such as the Royal Bank of Scotland, and given the particular circumstances that apply there, what factors might you take into account? I am thinking of, for example, capital injection by the UK Government, entry into the asset protection scheme, the European divestment requirements that have been published in recent months, and other factors of that sort. Would those factors influence the rating that you provide to such an institution?

Richard Hunter: I believe that the rating that we upgraded in December was the bank's individual rating. That immediately sounds somewhat archaic, but it is an important hook to move on to discuss how we look at banks. In effect, we have two rating scales for banks. Everyone is familiar with the AAA scale, but we also have what we call the individual scale, which is A, B, C, D, E and F. That marks the bank against our expectations or our view of its vulnerability on a standalone basis. It is possible—it was the case for Germany for many years—for banks to be rated towards the foot of that scale, at the D or E level, which is low and would certainly be a sub-investment grade on a standalone basis, but to have quite high debt ratings on the AAA scale because our belief was that the Government or lender of last resort would step in.

That is the situation in which we now find ourselves with RBS. The long-term rating is AA-, which is quite a high rating, but the individual rating is D/E, which, if you translated it across to the AAA scale, would be a speculative grade rating. It moved up from E, which is the next step to failure, to D/E, which is two notches above that. That really speaks to the topic of its financial standalone strength. In assessing that, we consider the bank's capital adequacy, its ability to make profits, its risk management and various other measures—basically, everything except how systemically important or otherwise likely to be supported the institution is.

RBS is a good example. Somebody who looks at it can clearly tell the difference between an RBS, which has a D/E and a long-term rating of AA-, and a bank that has a rating of AA- on its own merits. AA- is, in effect, the floor at which we have put major UK banks based on the level of Government support through things such as the asset protection scheme.

Lewis Macdonald: In other words, barring a dramatic change in Government policy towards such banks, there are no circumstances that would remove that AA- standing.

Richard Hunter: I would not necessarily use the word "dramatic". We have a certain number of notches that we can play with. If there was a significant change in policy towards supporting the banks, there are bank support floors that are below AA- and it would be possible to use them. We do not anticipate that right now, and certainly from the modest improvement in the individual rating, it seems that things are getting marginally better for RBS. It is possible that the country floor on which the senior rating is resting could move without a dramatic change, but it would have to be fairly significant.

Lewis Macdonald: Over what period is it possible that the D/E rating will improve and move somewhat closer to where it was before the current situation began?

Richard Hunter: Before, it was at A/B, so it was very close to the top of the scale. It would be difficult to tell and it is slightly off my bailiwick to discuss how long that would take.

Lewis Macdonald: Sure, but to achieve profound and significant improvements in capital availability and profitability—

Richard Hunter: Typically, it would take a while. For example, to leave RBS to one side, if a bank was rated very low and we simply said, “There’s one factor; let’s give it an awful lot more capital”, but there were still question marks over the profitability, the quality of the loan book, the asset profile and investment strategy or whatever, that would need to be factored into whether there should be an upgrade in the individual rating. We have many banks that have optically high capital ratios but which are low rated because they have other challenges.

Lewis Macdonald: Do you expect there to be any convergence between your rating of the Royal Bank of Scotland and the divestment by the UK Government of its majority shareholding?

Richard Hunter: Convergence in the sense of?

Lewis Macdonald: Would the factors that might lead UKFI to dispose of its shareholding on behalf of the Government be the same factors that would persuade you to upgrade the rating of the institution?

Richard Hunter: I am afraid that I am not aware of UKFI’s exact mandate for relinquishing, whether it is profit maximisation for the Government or a desire to get the bank back into the private sector as quickly as possible. It would depend on that. If it were a desire to get it back into the private sector as quickly as possible, there might be a reasonable level of convergence.

Lewis Macdonald: Lloyds Banking Group has some state ownership too. Would the kind of rating that it might attract be influenced by, for example, its decision not to enter into the asset protection scheme in the same way that the Royal Bank did?

Richard Hunter: That is getting into the details of individual bank ratings. I could ask a colleague to give you more information on that.

Lewis Macdonald: That would be helpful.

The Convener: I will conclude by asking a question that ties in with our previous evidence session on the auditing of banks with the auditors and representatives of the accounting profession. To what extent do you take account of companies’ audit certificates when you rate them?

Richard Hunter: We take account of them in numerous ways. First, we look at what the audit statement says. Believe it or not, some audit statements do not actually amount to audits. A particular type, which I believe is called a compilation, allows an auditor to put a note on the front of the report that says, “We have compiled this” when they have taken literally no interest in the truth and fairness of the view contained therein. Compilations are relatively infrequent and might be a peculiarity of the United States.

We would look at whether the audit was qualified and ask whether it was a material qualification—in other words, whether we thought that the company was not a going concern—or one of a more technical nature. In most cases, the companies that we rate tend to have unqualified audits. At that point, the only other thing that we would look at would be the auditor. In reference to Mr Harvie’s earlier point about whether it is acceptable for a company to be rated by an auditor that no one has heard of, if somebody has an auditor with whom the rating committee is not familiar, we have a process to check why that is and find out whether they have credentials that would satisfy us. Typically, it is very rare that one of our ratings would be based on financial statements that use an audit from outside the large, internationally recognised auditing firms.

The Convener: We touched on this earlier with the auditors, but when you do your credit ratings, to what extent do you look at whether the value of the assets stated by the companies is genuine—in other words, the price versus value differentiation that we spoke about earlier? I do not know whether you listened to the earlier evidence.

Richard Hunter: I agree with the witness from the auditing profession who said that we should not make a distinction between price and value. Ultimately the value will be the price at which it can be sold; there is no point in saying that a thing has a value of X if the only person prepared to buy it will do so for one tenth of X. That is clearly the case for the auditors because they are looking at statements that have been prepared for them to review. From the rating perspective, however, if somebody came to us with a balance sheet that had an enormous amount of goodwill on it because they had made a large acquisition, although that would have a significant impact on the company’s balance sheet, we would not look at it particularly. Instead, we look at the fact that the company has made a big acquisition and ask how much cash it will pay off. Then we ask whether it will make enough cash out of the acquisition to pay off the debt that it raised to finance the acquisition, make a reasonable return to the shareholders and be able to do all that with the level of credit risk in its current rating.

We tend to be able to be more flexible than auditors and more interested in looking not at what the market value and market price is—those terms can be used more or less interchangeably—but in saying, “Well, that might be the market value today, but what will it be over several years?” As a case in point, we rate commercial property companies in the UK whose ratings, funnily enough, have not moved that much in the past two years despite the profound fall in commercial real estate values.

We knew that there would be a cycle and that the values would come down again. There has been significant commodity price movement for metal companies, and with oil priced at $170 a barrel there has been a significant up-stream boom for some oil companies, but we have not moved their ratings up in order to move them back down again. We look through that question of value to see what we think a through-the-cycle valuation might be. That is more the type of work that we do. I would not contradict the auditors who are effectively obligated to take a price-based value.

The Convener: Thank you. It would be interesting to hear what your valuation of Kraft is after its debt-funded acquisition of Cadbury, but perhaps that is a matter for another day. I thank you for taking part in that lengthy evidence-taking session. It was helpful in giving us a better understanding of the role of credit rating agencies.

Richard Hunter: My pleasure.

The Convener: Next week will be our penultimate evidence session in this inquiry. Martin Currie Investment Management has agreed to give evidence and we will fit that into our meeting on 24 February. Next week we will hear from the Financial Services Advisory Board and the finance sector jobs task force. We will then hear from the Cabinet Secretary for Finance and Sustainable Growth.

We now have a full house for our visit to London next Tuesday. We will meet Lord Adair Turner, the chairman of the Financial Services Authority, and representatives from the Treasury Committee of the House of Commons. We will also observe a meeting of that committee. We will meet Mervyn King, the governor of the Bank of England. We will attend a meeting of the future of banking commission and, finally, we will have a meeting with Lord Myners, the Financial Services Secretary and Minister for the City. We will meet a good number of people who should provide us with some useful information to assist us in our inquiry.

Rob Gibson: It is just a pity that the mountain has to go to Mohammed.

The Convener: I thank everyone for what has been a long but interesting meeting.

Meeting closed at 13:42.

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