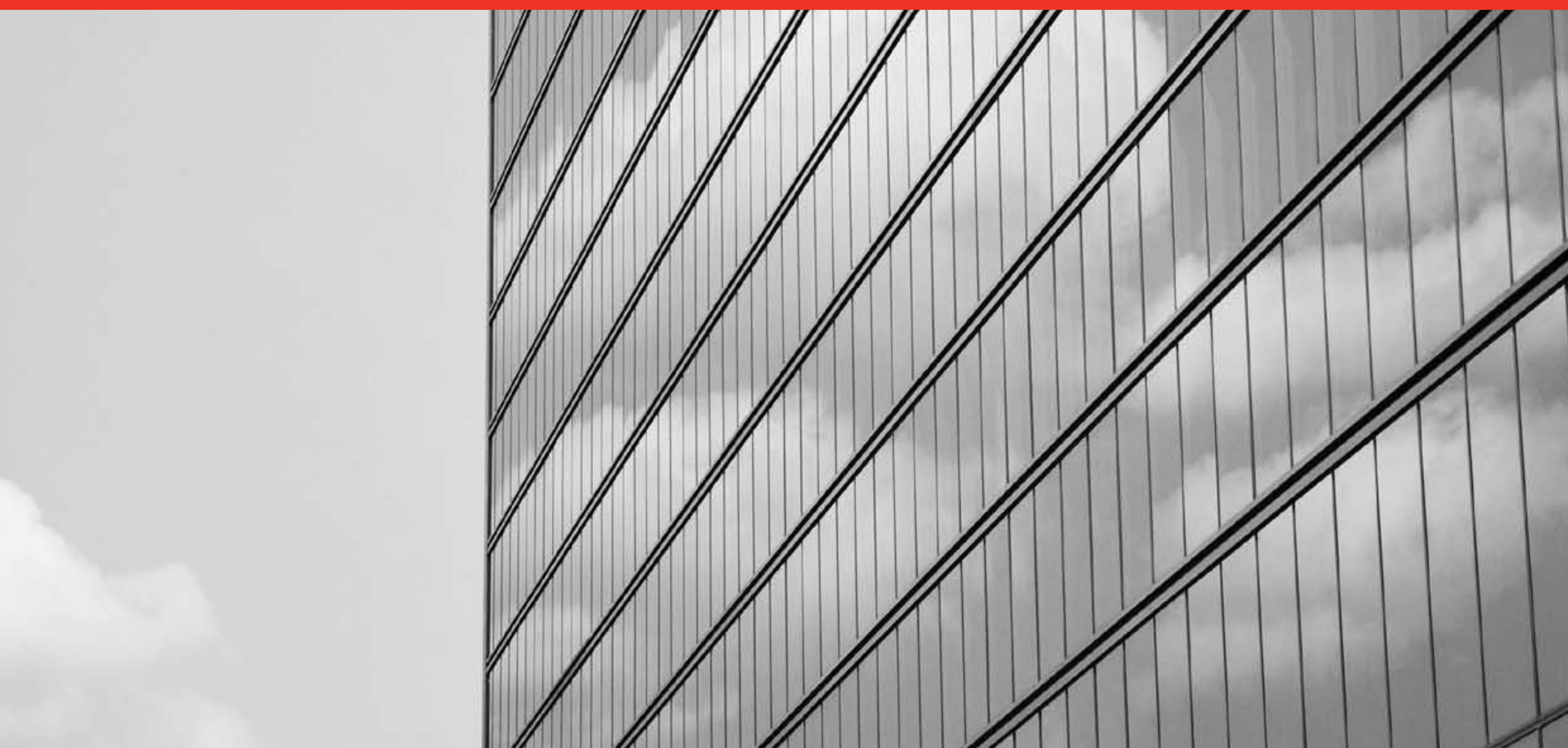
POLICY PAPER

The Future of Financial Regulation



ABOUT ACCA

ACCA (the Association of Chartered Certified Accountants) is the global body for professional accountants. We support our 131,500 members and 362,000 students throughout their careers, providing services through a network of 80 offices and centres. Our focus is on professional values, ethics, and governance, and we deliver value-added services through 50 global accountancy partnerships, working closely with multinational and small entities to promote global standards and support.

We use our expertise and experience to work with governments, donor agencies and professional bodies to develop the global accountancy profession and to advance the public interest.

AUTHORS

ACCA would welcome comments on this paper and looks forward to contributing further to the current international debate.

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1. Introduction

The current global financial crisis has been the biggest of its kind for decades and will have consequences that will be with us for many years to come.

The first steps in the worldwide response to the crisis have already been taken. Governments in many countries have borrowed huge amounts of money to help beleaguered institutions in the financial sector to survive. In some cases massive public support has also been extended to strategically important businesses in the 'real' economy.

Nonetheless, these are only the first steps in what must be a longer process. What is also essential is that we understand exactly what went wrong and take appropriate action to ensure that the financial system as a whole is more resilient and is better able to withstand future shocks of this magnitude so as to contain their consequences for the wider economy.

The scale of the impact of the financial crisis explains why there is currently so much interest being expressed in respect of regulation. If we are to make meaningful improvements, we need to understand whether some aspects of regulation contributed to the problems and possibly encouraged them, whether companies and financial institutions could have acted more responsibly, and if aspects of individual behaviour need to be addressed.

This paper is intended as a contribution to this process and is presented as a guide for governments, regulatory authorities and standard-setters. The paper is in two parts: the first sets out to explain the nature of the crisis and the second lays down a number of principles which ACCA believes should be reflected in the future design and administration of regulatory systems in the financial and business sectors.

The report incorporates comments provided by many senior figures from the finance industry and accountancy profession in major capital markets around the world, sourced by ACCA's network of national offices. It also draws on opinions offered at a round table event held in London, which was attended by bankers and financial services professionals. A full list of contributors appears at the end of the paper and ACCA thanks all contributors for their time and informative insights into this important subject. The contents of this report represent ACCA's own opinions and conclusions and so do not necessarily reflect the views or policies of either the individuals quoted or the organisations for which they work.

SUMMARY

1. The apparent recent failures of the 'light touch' approach to regulation should not lead authorities to conclude automatically that a heavy-handed approach would be the appropriate solution. While it is understandable that governments wish to be seen taking decisive action in response to crises, it must be recognised that regulatory failures have occurred under both types of approach. The crisis in the banking sector occurred not because of a lack of regulation – the sector has in fact been subject to a very extensive rulebook – but because of the ineffectiveness of that regulation. Regardless of the conceptual approach adopted, what is essential is that regulatory authorities are effective in carrying out their various functions, in particular the supervision of regulated entities, and succeed in their regulatory objectives.

2. The element of competition is key to effective regulation. The greater the size and complexity of a business, the more difficult it becomes not only to regulate but to manage. The phenomenon we have seen of banks that are 'too big to fail' must stimulate governments and regulators to promote healthy competition in the marketplace, both for the benefit of the wider economy and for the achievement of more effective regulation. The benefits of competition should also be borne in mind in determining the extent to which international alignment of regulatory practices is appropriate. Moves initiated by the recent G20 meeting of world leaders to encourage the sharing of knowledge and best practice on a global or regional basis are welcome, but this does not necessarily mean that uniform requirements and procedures must be adopted by all regulators regardless of local market circumstances.

3. The framework of regulation adopted in any country must have a clear purpose that is understood by regulators and regulated entities alike. In the banking sector, the protection of depositors should be seen as the principal objective in the context of encouraging public confidence in the system. There must be mechanisms in place for ensuring effective communication between the two sides, and regulators should endeavour to generate a positive commitment on the part of regulated entities to the achievement of the objectives of the process. Regulatory authorities must also have sufficient resources to ensure that the market knowledge and skills of their staff are, and remain, adequate for the purpose of exercising the effective supervision of complex business structures and evolving business practices.

4. Regulatory authorities should take reasonable steps to ensure that regulated entities possess the skills and experience, at all levels of the business, necessary for them to comply with regulatory requirements and protect the interests of their stakeholders. Authorities should also encourage the adoption, in financial institutions, of ethics-based corporate cultures that have the aim of ensuring that they act transparently and with a real appreciation of the long-term interests of their stakeholders.

5. Regulators should adopt a systemic approach to the safeguarding of stakeholder interests, ensuring all relevant factors are addressed effectively. In the financial sector, this means, among other things, taking wider macro-economic factors fully into account. This will complement more effective monitoring of the capital and leverage ratios of individual institutions. The activities of specialised entities that are currently outside the regulatory net should be reviewed and, where appropriate, brought within its scope.

6. The accountancy profession must consider ways of making the processes of financial reporting and auditing more useful to stakeholders. Enhancing the quality of reporting on risk should be central in this context, but it is neither necessary nor desirable to redesign accounting standards so as to meet the specific information requirements of regulators. Information that regulatory authorities need for their purposes should be obtained separately, via dedicated prudential rules.

7. The crisis has highlighted a number of serious weaknesses in corporate governance and risk management practices, even among companies which followed the express requirements of official guidance on these matters, and these failures need to be addressed. There needs to be a specific review of the role of non-executive directors, and in particular consideration of whether new measures could be taken to enhance their effectiveness in exercising supervision of the executive in large and complex institutions. Companies can also do much more to engage with their shareholders and to encourage them to play an active but responsible part in the governance process.

2. The nature of the financial crisis and its consequences for regulation

Regulation has rarely has such a high profile. Formerly seen as the natural preserve of back-office compliance staff, it has become big news since the global credit crisis and dominated much of the thinking of world leaders at the April 2009 G20 summit in London.

Why is this? Politicians are determined to ensure that the unprecedented financial crisis – and the widespread public anger at the behaviour of banks, which was one of the principal causes of it – can never happen again. Given the scale of taxpayers' money required to shore up banks' balance sheets, it is understandable that governments seek to reassure their electorates that lessons have been learned. Stronger regulation is seen as a visible way of proving that point.

But have the right lessons been taken on board? Was the crisis essentially a regulatory failure? Or were there other more important factors? And what should the regulatory system of the post-crisis world look like? This paper reviews these issues and suggests a number of principles which should underpin effective systems of regulation.

ACCA has consistently argued[1] that the crisis was more a failure of governance in banks than of regulation per se. A lack of accountability, both within financial institutions and between management and shareholders, was at the heart of the problem. This led to the following problems:

- failure in institutions to appreciate and manage the interconnection between the risks inherent in their business activities and management and remuneration incentives
- remuneration structures/bonuses of banks were characterised by short-term goals, which neither supported prudent risk management nor worked in owners' long term interests
- risk management departments in banks did not have sufficient influence or power
- weaknesses in reporting on risk and financial transactions.

Further contributory factors identified were:

- the over-complexity of financial products and lack of management understanding of the associated risks
- an over-dependence on debt
- the scale of issuance and the interconnectedness of financial institutions
- human weaknesses: a failure to appreciate the influence of cultural and motivational factors such as rigidity of thinking, lack of desire to change
- the lack of rigorous challenge by non-executive directors possibly caused by poor understanding of the complexities of the business
- bad habits and complacency after a ten-year bull market.

These, and related, factors have been subsequently picked up by a series of high-profile reports which have recommended new regulatory principles in an attempt to address them and to fix the wider financial system. These reports include:

- *Financial Reform: A Framework for Financial Stability,* The Group of Thirty (G30) (chaired by Paul Volcker), January 2009
- *The Global Economic Crisis: Systemic Failures and Multilateral Remedies,* United Nations Conference on Trade and Development (UNCTAD), February 2009
- *Lessons of the Financial Crisis for Future Regulation of Financial Institutions and Markets and for Liquidity Management,* IMF, February 2009
- *The Turner Review: A Regulatory Response to the Global Banking Crisis,* FSA, March 2009
- *Financial Supervision and Stability in the EU* (the De Larosiere Report), European Commission, March 2009.

1. See *Climbing Out of the Credit Crunch*, ACCA, September 2008, <www.accaglobal.com/pubs/general/activities/library/governance/cg_pubs/credit_crunch.pdf> and *Corporate Governance and the Credit Crunch*, ACCA, November 2008, <http://www.accaglobal.com/pubs/general/activities/library/governance/cg_pubs/cg_cc.pdf>.

There is a large degree of agreement in these reports, and they all propose a considerable toughening of the 'light-touch' approach to regulation that is now deemed to have failed to prevent the crisis. It should be noted, though, that some of the G20 leaders who have called for heavier regulation in the light of the banking crisis were praising that same light touch approach just two years ago. The lesson from this is that great care should be taken when the new system is put together and knee-jerk reactions to political demands carefully avoided. Many would argue that, while a strong reaction on the part of the US government was inevitable following the Enron debacle, Sarbanes–Oxley ('Sarbox') was nonetheless an over-reaction to that crisis which in turn created its own problems. We should recall the mistakes made during that episode before jumping to easy conclusions this time.

In this paper, ACCA has drawn upon the views of its members but also those other business and financial leaders from key financial centres around the world. It is crucial that, in an interconnected global economy, views from broad perspectives and a wide range of capital markets are heard.

NATURE OF REGULATION

Before we discuss the specifics of banking regulation, it is worth examining aspects of wider business regulation – and the starting point for any analysis of regulation is to be clear about what it is intended to achieve.

ACCA believes that the purpose of regulation is to facilitate legitimate and competitive business activity, while providing safeguards for the interest of stakeholders. The important point to note here is that regulation, which has acquired, certainly in Western markets, a negative 'red-tape' connotation, should be regarded as making a positive contribution to business success. If it is not doing this, the regulations should be reviewed.

A 2007 survey by ACCA and CFO Research Services showed a distinctly more positive response to business regulation in South East Asian markets, where it was regarded as strengthening rather than hindering shareholder value.

In the report, *A Critical Connection: Making the Link Between Regulation and Shareholder Value*, 176 senior finance executives in China, Singapore and Malaysia were surveyed, and almost 60% believed regulation enhanced shareholder value (defined as the ability to deliver sustained steady growth in share price and cash flow over the long-term) while fewer than 25% believed it hindered economic growth. Executives said effective regulation allowed them to focus more on strategy, and had a positive impact on the key drivers of shareholder value within a business, such as data quality and risk management controls – the very issues that have proved to be a key weakness in US and European banks.

International Financial Reporting Standards, tax regulations and stock exchange regulations – all of which aided investors and helped to place Asia-Pacific markets on a level playing field with the US and Europe – were viewed as the most helpful rules in creating shareholder value. Interestingly, even Sarbox, widely regarded in the West as the epitome of knee-jerk over-reaction to a crisis, was found to be helpful by over half of respondents in the south east Asia region. Sarbox replicates financial disciplines, processes and internal controls which already existed for most UK and US companies, but in the dynamic South East Asian market many newer businesses found it useful that everything had to be documented and audited, giving the business more confidence to focus on growth.

There are two crucial points here. The first is relevance – the regulations were seen as directly applicable and appropriate for the markets. The second is the right motivation – regulations were seen to be genuine attempts at increasing transparency and helping businesses prosper, rather than as a way for governments to further social goals or raise revenue by burdening business. Any additional form of regulation should pass this 'acceptability' test.

The final point of note was mentioned by one Chinese regulator, who said he had to 'consider the benefits and cost of securities regulation from the view of the whole capital market, not a single company. The key factor is balance and it is always difficult for the regulator to make a decision. If we can achieve balance, shareholder value will increase.' Regulation only works when it is applied and enforced consistently.

ACCA would also point to lessons learned from the regulation of its own professional accountancy sector, which can be applied to the banking industry. First, the era of self-regulation passed in the 1990s when it became clear that a situation where the regulatory structures were controlled and funded by those being regulated no longer commanded sufficient public credibility to be acceptable. At the other extreme, direct government intervention in regulatory and monitoring processes can undermine legitimate business and professional judgements.

Instead, the generally accepted model for the profession now is one where a strong independent central regulator is required, one with robust and transparent public oversight. The governing board or council of a professional regulator should consist of a relatively small number of individuals and should be representative of the major stakeholder groups. There should be public oversight of the system with heavyweight industry experts involved in monitoring, who have legal and regulatory teeth to pursue issues identified. There is also separation of policy making (rules and regulations) and compliance (monitoring and enforcement).

BANKING REGULATION

Turning specifically to banking regulation, the G30 report refers to the need for a system 'in which those responsible for prudential regulation and supervision have a high degree of political and market independence and the resources necessary to supervise giant institutions and to keep abreast of market innovations'. We would strongly support this view.

The G30 report also calls for 'stronger regulatory incentives for holding large (systemically significant) institutions to the highest standards of governance and risk management'. It has already been made clear that ACCA believes the crisis to be essentially one of governance. Risk-based and principles-based regulation should be at the centre of any new system and Large Complex Financial Institutions (LCFIs) should be expected to satisfy the authorities that they are continuously, actively and competently managing risk in the particular circumstances of their business. Regulators need to be acutely aware of responding appropriately to those firms that have fundamentally changed their business model.

This means targeting those banks that are strategically important with specific and tailored regulatory policies, rather than using a 'one size fits all' approach. ACCA agrees with the suggestion that there should be a form of 'systemic risk surcharge' for certain institutions, requiring them to hold more capital against risks. The Turner and de Larosiere reports, amongst others, argue that there is currently no adequate way of regulating LCFIs. ACCA supports the concept of some form of segmented regulation, similar to the Glass–Steagall principles of separating investment banking from deposit taking, while recognising the practical difficulties of establishing a complete barrier between the two functions.

The Glass–Steagall principles are sound because they ensure clarity of purpose on what banking regulation is supposed to achieve. Given the severity of the collapse in confidence in financial institutions, it is essential that the public is reassured that consumer protection is at the heart of the regulatory system. A clear separation of deposit-taking from investment banking must be the aim. Effective and efficient compensation schemes must be part of the system, while the regulators should be urged to give more priority to increasing public 'financial awareness' as part of consumer protection. It is also important that consumers and their representative organisations are engaged in the regulatory process as far as possible.

There is going to be a natural aversion to risk-taking associated with complex products.

PETR KRIZ, PWC CZECH REPUBLIC

While this paper does not seek to make recommendations on the specifics of capital adequacy, ACCA agrees that Basel 2 needs reform by re-weighting the comparative liquidity risks with market and credit risks and being simplified so as to allow better practical application. With regulators, as mentioned by de Larosiere, seeking to reduce the problem of pro-cyclicality in the existing capital (and accounting) rules, we are attracted by the Bank of Spain's policy of carefully scrutinising banks' internal provisioning models or imposing its own dynamic provisioning model. The aim is to allow an accumilation of a general cushion in good times, to be released in bad years as specific provisions for loan losses need to be made. This is the sort of measure that could be usefully made in the short term, while allowing proper consideration to be given to any longer-term structural changes.

ACCA believes that better micro-regulation by regulators in areas such as this could have prevented the huge increases in leverage in the banking sectors. In 2003–4, after the easing of the Glass–Steagall Act in the US (and a possible delayed reaction to the dot-com crash of 2000) banks' ratios of capital to debt increased from 1:12 to up to 1:40. It is hard to dispute that keeping a closer eye on individual banks would have been worthwhile here.

ACCA supports the Dubai Financial Services Authority's submission to this paper, which like that of other significant institutions, highlighted the need for systemically important products and instruments to be regulated. The DFSA gave the analogy of how new medical products are examined by the Federal Drugs Agency to ensure their impacts are understood. This is an idea worth further consideration.

INTERNATIONAL COORDINATION

The difficulties of regulating LCFIs would be immense even if they were purely national firms, but the depth of the problem was shown most starkly by the crash of the so-called 'global in life, national in death' firm Lehman Brothers. This left administrators in various countries dealing with very different insolvency rules, which cannot be sustainable.

It is essential that there is greater cooperation and coordination between national governments and regulators, although the G20 summit understandably stopped short of calling for a single global regulator, given both the principles of subsidiarity and the reality that national sovereignty demands that national regulators carry out day-to-day activity in each country. It can be reasonably argued that a global regulator could only function if there were a global government.

Enforcement must be carried out at national level. Regulators should be close to those being regulated.

PHILIPPE DANJOU, EX-DIRECTOR, AUTORITÉ DES MARCHÉS FINANCIERS

A sensible model was put forward by the de Larosiere committee, which proposed a European Systemic Risk Council to bring together representatives from all the central banks and financial regulators in Europe and for a binding mechanism to be set up to ensure that such greater macro-prudential findings are followed through by micro-supervisors in the various EU states. Philippe Danjou,[2] a former director of the French securities regulator, the Autorité des Marchés Financiers, and currently a member of the International Accounting Standards Board (IASB), believed this was a much more attractive approach than trying for a 'European SEC'. While regulations and standards can be agreed at a regional level, practical supervision and enforcement need to be carried out at a national level. Danjou said the secret of good supervision was to be close to the institutions being regulated, using the analogy of a good police officer knowing his or her 'beat'.

An issue that arises here, though, is that of 'who pays?' when there is a crisis. As we saw with Lehman Brothers, it was not 'colleges of supervisors' who discussed the issue over the crucial weekend, but finance ministers. Politicians have a key role to play here in upholding agreements, rather than undermining them as we have seen in the field of accounting standards, with banks in both the US and Europe successfully lobbying their own governments to secure concessions to 'mark to market' rules from the International Accounting Standards Board (IASB), which is meant to be an independent body. Such short-term political loss of nerve can only damage the prospects of global accounting standards at a cost of long-term damage to business and does not bode well for wider financial regulation.

It is essential that the new body, the Financial Stability Board (FSB) – agreed at the G20 meeting – works well with the International Monetary Fund to spot developing risks in the world's financial system and to provide early warning of emerging problems. The board has already made pronouncements about the future supervision of hedge funds and credit rating agencies and, it appears, the FSB will also review the existing standards-setters such as the IASB and the Basel committee. It is essential that they do this with the long-term interests of the world economy in mind.

2. Danjou is speaking in a personal capacity and not on behalf of the IASB or its staff.

The G20 leaders also committed themselves to achieving higher levels of cooperation between authorities in their different countries and consistency in regulatory practices. ACCA believes that the regulation of the financial sector will be enhanced if coordination in matters of controls and standards can be achieved in practice. Learning from best practice is one way to achieve this. Many of those spoken to in the compilation of this report called for more regular formal and informal forums where national regulators could discuss issues of common interest, particularly at regional level where there may be common cultural understandings.

The success of any regulatory regime is the ability to protect ordinary investors before an unpredictable man-made disaster happens.

US FINANCIAL REGULATOR

The regulation of the financial system should certainly aim to reflect the system's global character but it should at the same time respect the fact that different countries and regions are at different stages of market development. And it must also be understood that the imposition of regulatory rules on a standardised basis in all markets may be not only unrealistic but undesirable. For example, in relation to regulatory strictures for company boards to appoint a minimum number of non-executive directors, there may not always be an adequate pool of individuals who are sufficiently qualified and experienced to perform that role effectively. And if all countries imposed uniform regulatory standards, and we subsequently experienced another major crisis, all countries would suffer in exactly the same way.

In pursuing a strategy of coordination, it should be borne in mind that the impact of regulation depends to a great extent on the effectiveness with which regulatory authorities carry out their responsibilities: this aspect will, as ever, call for adequate levels of resources to be made available. It seems likely that the international community will need to address not only the issue of achieving coordination of standards but also the implications of resources for consistency of application.

Given also that the effects of problems in the international financial system have the potential to exert an immediate and lasting effect on all countries, any new international structures to be established should be truly global and should allow the voice of the developing world to be heard.

ACCA firmly agrees with UNCTAD and the World Bank that the developing countries must be given a safety net in any revised global system of regulation. The emerging economies in Africa, Asia, Latin America and Central & Eastern Europe have a huge role to play in boosting the world economy and it is essential that their interests are fully recognised. One concrete way of doing this is by undertaking a review of the international bodies themselves, such as IMF and the World Bank, which were set up in the post-war era and whose membership reflects the needs of that era. Just as the G7 has become the G20, all such bodies need to adjust to modern realities.

COMPETITION OF IDEAS

Although ACCA believes that greater coordination and learning between regulators is important, it is essential that improved cooperation does not exclude competition of ideas. We have already made reference to the Bank of Spain's current work on provisioning, which other national regulators should examine for applicability to their own domestic markets. Regulatory arbitrage must be prevented, but it is vital that regulators continue to originate solutions and ideas. In the US, having one dominant accountancy body did not prevent the Enron accounting debacle, while the bailed-out mortgage providers Freddie Mac and Fannie Mae effectively had their own regulator. Healthy regulatory competition can prevent the risks of complacency.

INTERNATIONAL BANKING

The internationalised and interconnected nature of the modern banking system makes it essential that whatever steps are taken to enhance the effectiveness of the regulation of the sector, they are coordinated as far as is practical. The big retail and investment banks operate on a global basis and their successes and failures have consequences for economies across the world. It should follow that the systems and practices adopted for the purpose of regulating such entities should aspire to adopt and enforce common standards, albeit with provision made for significant variations in market conditions in different countries and regions.

It is also important that authorities recognise the cross-border realities of banking business. The president of Germany's Bundesbank[3] has argued that the European Commission's tougher rules on state aid for banks, introduced as a response to the financial crisis, will have the side-effect of making lenders withdraw from cross-border markets and become more nationally focused. Regulation should not focus on short-term problems at the expense of damaging business in the long term.

HEAVY OR 'LIGHT-TOUCH' REGULATION?

It is understandable that some of those we contacted in the preparation of this paper argued that the time for heavier regulation had come. Edgar Zhi, RBS's CFO in Shanghai, said that the relatively minor damage suffered by Chinese banks showed that 'an interventionist and hands-on approach would be more effective in regulating the current financial services industry, especially for derivatives and creative products. A highly leveraged balance sheet should not come under light touch regulation methods.'

In Johannesburg, there are those who argue that South Africa has been well insulated from the world economic crisis by stricter credit regulation. Raj Mahabeer, CFO, Auditor General's Office, South Africa, believes that 'the world needs a highly regulated banking sector, which should be rules-based. Any transgression should be penalised harshly, including imprisonment of certain leaders and shareholders. Such additional regulation will result in better control of our economies and the promotion of real growth'.

And in Europe, Danjou pointed to the relative lack of exposure of French banks to riskier activity compared with the UK as a possible indication that heavier regulation, such as tighter rules on bank capitalisation than was required by international standards, had proved effective in avoiding the worst of the trouble. He accepted, however, that this was not proof of a causal link, and it can certainly be argued that the traditional caution of French banks in lending to homebuyers and other borrowers was equally significant. Danjou also argued that it was essential that regulation should cover 'shadow banking' activities and that all assets and liabilities were brought back onto banks' balance sheets.

Associating 'light-touch' regulation with 'principles-based' and intrusive or close monitoring with rules-based is misleading. Those terms are not mutually exclusive.

DUBAI FINANCIAL SERVICES AUTHORITY

Other experts consulted in the compilation of this report believed that the risks associated with off-balance sheet exposures were not always clearly understood, and their ramifications not always evident. One of the Big Four firms in Dubai said that 'in many cases what was perceived to be an off-balance sheet activity turned out to be an on-balance sheet one, or became one, for example implicit support provided by the banks to service the CDO tranches in order to protect themselves against the reputational damage at the time of default'. ACCA would agree that institutions such as hedge funds and private equity firms must also be regulated – if quasi-banking activity is happening it should be regulated, no matter what the name of the institution.

Detailed rules-based regulation may have an understandable attraction for politicians in the light of the crisis, but it can be convincingly argued that the problem in the banking sector was not lack of regulation – of which there was no shortage – but a lack of effective supervision. Too often regulators suffer from an insufficient number of skilled and experienced staff to supervise complex institutions properly. Adequate funding of the new regulatory system is essential if it is to make a real difference.

3. Axel Weber in an interview with *Financial Times*, 22 April 2009.

Although there will always be a remuneration gap between regulators and banks, the UK's FSA is making efforts to bridge the gap by providing more attractive packages. A senior FSA representative said the regulator was recruiting experienced staff as it enhanced its supervisory approach and applied the increasingly intrusive style, as outlined in the Turner Review. This additional recruitment had also enabled the FSA to increase its 'significant influence' function reviews, which have led several individuals to withdraw applications to take up senior City positions. The FSA said, however, that it had 'to be mindful not to stifle innovation. We do not want to regulate firms out of existence'. Striking the right balance is the key.

Richard Sun, a PricewaterhouseCoopers (PwC) audit partner in Hong Kong SAR, argued that it was essential that regulators made every effort to understand their markets and commit their staff to keeping up to date. Edgar Zhi also said that regulators were 'often academics and from government bodies rather than banking and so lagged too far behind the advanced banking behaviours and products'. More hands-on experience was essential. Several of our respondents pointed to the growing skills gap between the regulators and those regulated.

These days a typical problem of the regulators and NEDs is that they are too far from the banking industry.

EDGAR ZHI, CFO, RBS BANK, SHANGHAI

Even for those regulators with sufficient resources and knowledge, are there still inevitable limitations as to what they can achieve in terms of risk assessment?. Sun said he believed that risk management had risen sharply up the agenda in China, with companies typically having separate risk-management committees.

Yet the late Lord (Eddie) George, former Governor of the Bank of England, said in a lecture in September 2008: 'I don't know of anyone who saw the sudden freezing up of the wholesale markets coming as it did, and I don't see how one can realistically expect the regulator to foresee what happened when the financial experts operating in the marketplace didn't.'[4]

Is this a reasonable statement of reality or an attempt to deflect blame from regulatory failure? Regulators had effectively given their blessing to diversification and the spreading of risks via securitisation. Many management teams and boards considered they were following the new best practice and managing risk effectively by transferring the risk of mortgage default to the buyers of the securities – especially given that they were usually AAA rated.

Is it inevitable that regulators will always be one step behind those who are determined to find the loopholes in any system and push the rules to their limits? ACCA believes we must recognise that the spirit of enterprise encompasses innovation and pushing of boundaries. We cannot afford to crush this spirit if we are to allow humankind to benefit from wealth creation and economic growth. So the challenge is to create a control framework which is not a straitjacket: it could be argued Sarbanes–Oxley came close to this and it is where over-centralist remedies could take us.

The accountancy profession has much to contribute in terms of fresh thinking on financial reporting and auditing, which are key parts of any financial regulatory system. Although some audit partners we spoke to insisted that auditors were now asking more intrusive questions of clients than ten years ago – PwC's Sun talked of the 'watchdog becoming a bloodhound' – others believed that expanding the scope of audit from checking financial statements to companies' risk strategies was the key. The Dubai Financial Services Authority also floated the idea of expanding the audit committee's mandate to include risk.

4. Annual lecture to The Worshipful Company of Chartered Accountants, Cass Business School (3 September 2008).

It must be remembered that no regulatory system is cost-free. The impact of compliance costs is always greatest on smaller companies, which will be the source of much of the economic recovery. A Big Four partner in Dubai warned that adoption of a rules-based approach, while helping in areas such as capital and liquidity management, ran the risk of incurring a 'high cost of regulatory compliance resulting in an extra burden affecting profits, and limiting necessary financial innovation – especially if these rules are derived as a reaction to the recent crises and written in haste'.

It is essential that light-touch regulation, which has become so disparaged in the political debate, is not regarded as being synonymous with a principles-based approach. As the DFSA has pointed out, such an assumption is 'misleading'. ACCA believes that a principles-based system, sufficiently flexible to be relevant in a fast-paced business environment but with stronger emphasis on ethical codes and practices, should be the bedrock of the new approach. While recognising the complexity of trading in global markets (and addressing the over-complexity of some of the financial products, which was a major cause of the problem) is essential, regulation should nonetheless be grounded in simplicity.

'Auditors too need to assess more forward-looking risk information and not just financial statements. Accounts are important but out of date.'

DAVID WU, PWC ASSURANCE PARTNER

ACCA believes instinctively in market solutions rather than government intervention, but we think the financial crisis is such that all parties must work together to re-establish credibility in financial regulation. A recent McKinsey report points out that 'regulation is about solving problems that society or businesses cannot solve alone, as well as making trade-offs among different objectives and the interests of various stakeholders'.[5]

That report rightly points out that companies need to raise their sights and that lobbying against any regulation that affects their sector should not be the default position for responsible businesses: 'In the coming new era of regulation, executives and regulators need, more than ever, to learn from each other. Companies should take a strategic view of regulation and strive for solutions that benefit a wide range of stakeholders.'

This, ACCA believes, is the practical ethical approach that was lacking in the boom up to mid-2007, and that must be the basis of the new regulatory era. As Adam Smith, the father of modern political economy, taught the world, ethics and trust are the basis of an economy. We would be wise to revisit Smith in the search for the new regulatory regime.

5. *The McKinsey Quarterly*, December 2008: 'Managing regulation in a new era'.

3. Principles of financial regulation

The principles set out in the following pages comprise a number of what ACCA believes amount to core guiding aims for the regulation of business activity. They cover not only matters that stand to be addressed and controlled by regulatory authorities but also those that call for action by business entities themselves. They have been influenced by a number of concerns that have come to light as a consequence of the banking crisis that began in 2007 and are intended to apply primarily to the financial sector. They are, however, framed broadly enough to be capable of application, where appropriate, to the regulation of business activity more generally. Similarly, the principles are directed at the regulation of limited liability companies but may well be capable of extension to other types of entity, where there is a strong public interest in the conduct of their affairs.

3.1 PURPOSE OF REGULATION

The overriding purpose of regulation should be to facilitate legitimate business activity while providing safeguards for the interests of stakeholders and ensuring fair competition in the market. 'Safeguards for stakeholders' include:

- **deterring and restraining companies from pursuing illegal or excessively risky practices that have the potential to have wider social or economic consequences, and**
- **intervening and responding appropriately and effectively where breaches are considered likely to occur or have already occurred.**

The approach to regulation

Regulatory authorities should aim fundamentally to provide assurance to the stakeholders of regulated entities that a responsible authority is exercising the supervision and control over those entities that they as stakeholders are not in a position to do themselves, and to give them confidence that this is being done effectively.

Regulatory authorities should have a thorough understanding of the business sector that they are supervising and should aim to acquire a similar understanding of the operational practices of individual regulated entities.

An effective approach to regulation should aim neither to be ostensibly 'light touch' – which would risk undermining confidence in the integrity of the system – or excessively rules-based, an approach which risks causing regulated entities to lose sight of the overall objective of the regulatory process. The more sustainable alternative is to adopt a principles-based approach, which requires regulated entities to focus on the purpose and objectives of the exercise. Rules will always be needed, but the volume of the rules imposed on regulated entities, and the level of their prescription, needs to be kept within the limits of what is necessary in the context of the overall objective. It is also crucial that all rules imposed must be capable of supervision and enforcement.

The extent of the supervision that is appropriate in relation to particular types of entity and business activity will vary according to the nature of the entities and activities concerned and the risk posed to each entity, its stakeholders and the achievement of the overriding objective. Recent experience suggests, for example, that some types of activity and product, such as derivatives, do call for closer supervision than others. The regulation of any large and heterogeneous sector should not therefore assume that a uniform approach will always be effective: an effective system of regulation needs to be sufficiently adaptable to be able to deal not only with different levels of complexity but also with changes in the marketplace. What should always underpin the system is a strong commitment to principles, with an emphasis on ethical practices.

Compliance responsibilities should be imposed on entities on a proportionate basis and should not have the objective or effect of inhibiting innovation and legitimate business activity unreasonably. Individual compliance responsibilities should be commensurate with the regulator's need to know and should avoid imposing bureaucratic burdens that lack regulatory 'relevance'. In order to facilitate supervision, entities should be required to maintain full and accurate records detailing the actions they take to secure compliance with their various obligations.

Regulation of the business environment, in whole or in part, should adopt a systemic approach and aim to ensure that all factors with a bearing on the achievement of the overriding objective are addressed effectively. This systemic approach should take fully into account the implications of wider macro-economic factors for the effectiveness of regulation in the financial sector. In the case of the banking sector, the regulatory authorities and the central bank should actively contribute to the goal of achieving stability in the financial system. Depending on the area of business under review, relevant factors are likely to include capital levels, risk management, financial reporting, internal controls, external audit, corporate governance arrangements, actuarial practice and credit rating activities. Specialised types of entity that are currently outside the regulatory net, but whose practices may have material or indirect economic consequences for stakeholders, may need to be brought within its scope.

Supervisory procedures should ensure that entities continue to comply with their responsibilities and enable the authority concerned to identify quickly failures and weaknesses that may call for expeditious regulatory intervention.

Regulatory authorities should aim to establish effective communication links with regulated entities. This is desirable to achieve two outcomes. First, effective communication is needed to promote understanding among individual businesses of the purpose of the regulatory process and of the regulator's expectations of them. Second, it is in the interests of regulatory authorities that they encourage a positive attitude towards compliance on the part of the regulated community. They should take practical steps to convey to individual businesses that the process of regulation is intended to be a genuine attempt to increase transparency and to help good businesses succeed in a competitive environment. The intention should thus be that those subject to regulation should themselves benefit from the process in meaningful ways.

Effectiveness

It is essential that any regulatory authority is and is seen to be credible and effective, both by those who are subject to its scrutiny and by all interested stakeholders. This means supplementing necessary regulatory requirements with effective supervision of entities' compliance with those requirements. With this in mind, the requirements that are imposed on regulated entities must in the first instance be capable of being monitored and supervised by the authority concerned. Effective monitoring, supervision and enforcement must then happen in practice. To be in a position to achieve these ends, regulatory authorities need individuals who have skills, expertise and experience in the field being regulated and who are capable of remaining alert and responsive to developments in business practices. These factors will necessarily require authorities to have access to sufficient resources to allow them to perform their role properly.

It is also essential that authorities have a clear, strong and public commitment to carrying out their regulatory responsibilities. This commitment should be promoted from the top of the organisation and communicated to and adopted by staff at all levels.

As well as having the right human skills, effective regulation requires the authority to establish the procedures necessary to exert proper supervisory control and to be prepared to vary and add to those procedures where developments in business practices render it necessary. The banking crisis has shown how important it is that regulatory frameworks are designed and resourced in such a way that they are capable not only of dealing with increasingly complex structures, products and practices but also of devising effective regulatory responses to them. Regulatory procedures need to identify the types of information that are likely to be of material significance to the regulator in carrying out its functions and to ensure that such information is always available to the authority and to an appropriate level of materiality, taking risk into account. At the heart of these various procedures should be the goal of establishing an ethics-based culture among regulated entities.

Regulatory sanctions should be sufficient to encourage compliance in the first place and to penalise proportionately in cases of proven breach. Regulatory authorities need to be prepared to make full use of the powers that are available to them.

Accountability

Regulatory authorities should be independent of political control but accountable to the democratic authorities for the exercise of their functions.

3.2 COMPETITION

Governments and national and regional authorities should regard the promotion of healthy competition in the market place as crucial for enhancing the potential effectiveness of their regulatory systems.

One of the issues that needs to be addressed urgently in the international response to the global banking crisis is whether governments and regulatory systems – whether ostensibly 'light' or 'heavy' touch in nature – may have contributed to the scale of the crisis by allowing entities to become ever larger and more powerful. This process, whereby some markets have become dominated by fewer and fewer mega-entities, has led to questions about whether these entities have become too big to regulate. Are they now too big for governments to allow them to fail? It seems clear that the concentration of market power in the hands of a few very large entities has presented significant challenges to regulators. It is also beyond doubt that the economic importance of many such entities has caused governments around the world to take the view that on no account should they be allowed to collapse, even if it means spending huge amounts of public money to prevent it.

The implications of this continuing process of consolidation for the effectiveness of regulation are such that they need to be at the heart of the response to the crisis. Regulatory authorities should see the promotion of healthy competition as being a key aspect of their functions. Most importantly, it should not be considered that the scale of regulatory activity must always be allowed to expand in proportion to the increasing size of regulated entities. Instead, there needs to be an acknowledgement that as an entity becomes larger and more complex, there will be consequences for the effectiveness of regulatory activities of all kinds: these will include not only activities connected with external regulation but also those such as external audit, internal controls and board-level supervision of management. Governments and regulatory authorities need therefore to consider whether the level of market concentration that has been allowed to develop is itself an indicator of regulatory failure. Whether or not they agree that this is the case, they must address the fundamental point that the regulatory authority must always be capable of understanding the regulated entity and exerting effective supervisory and regulatory control over it. If they consider that the process of market concentration has gone so far that this capability is being undermined, they should consider acting to rectify the situation.

It should also be acknowledged, in the context of how regulatory authorities are likely to respond to issues of market concentration, that there are wider implications for competition. The instinctive reaction on the part of regulators may be to impose on entities in, for example, the financial sector very detailed compliance requirements, on the assumption that this is an appropriate risk-based response for them to make. It needs to be borne in mind, however, that extensive regulation can have the economically undesirable effect of discouraging participation in the market by smaller entities, thus tending to inhibit competition and lead to further concentration.

The issue of healthy competition is also relevant to regulatory systems themselves. The experience of the banking crisis suggests that the regulatory approaches that were adopted in certain countries, including Spain, Australia and Canada, have helped to ensure that those countries, and their financial institutions, have avoided the worst consequences of the crisis. Although there should certainly be pooling of information, best practice and experience among regulators, along the lines that have been suggested by world leaders, it may not be safe to conclude that there is any one best solution to the design of national regulatory systems that should be imposed on all countries, regardless of local market circumstances. It must also be borne in mind that different regulatory objectives are likely to be more appropriate for national, retail banks than for global, wholesale banks – in the former, consumer protection will be key while, in the latter, the main driver is likely to be the need to achieve transparency in the markets so as to enable participants to operate at speed and on a large scale.

Any new global framework should therefore allow for divergent approaches to be followed where the authorities reasonably consider such approaches to be effective for meeting the particular regulatory objective, and appropriate for application in the market concerned.

3.3 STANDARDS OF BUSINESS CONDUCT

Companies should be expected to carry out their activities in accordance with high standards of business conduct.

The role of the board

A company's board of directors is ultimately responsible for ensuring that the company complies with the requirements of the law, of regulatory rules and of any codes of practice (or similar) that it chooses or is obliged to follow. The board is also ultimately responsible for setting the tone for the various behavioural practices undertaken in the name of the company. The board should be expected to commit the company to standards of business conduct that aim to ensure, as a minimum, that the company conducts its business affairs transparently and treats fairly all those parties, both inside and outside the business, with whom it deals. Such action should involve, as a priority, ensuring the active commitment of both the board and senior management to company-wide policies and practices on standards of responsible business conduct that collectively amount to an ethics-based culture.

Members of the board, and members of any special committees of the board, have a particular interest in ensuring that all necessary information relating to the exercise of their functions, and that is available within the company, is transmitted to them. Members should be prepared to insist that the management of the flow of information to them is conducted in such a way as to ensure that they are provided with all the information that is or may be material to their decision-making and governance responsibilities.

The board should ensure that its policies and practices on business standards are observed by keeping their application under regular review.

The responsibility of individuals

Individual members of the board of directors (or equivalent) should act not only in accordance with their legal duties but with due recognition of the importance of high standards of business conduct for the long-term interests of their company. Individual employees should be expected to act in accordance with the policies and practices adopted by the company.

The role of the regulator

Regulatory authorities should note and act upon the following conclusion of the G20 meeting of April 2009:

'Strengthened regulation and supervision must promote propriety, integrity and transparency'.

This statement was intended to refer to the financial sector alone, but the objectives identified are appropriate for application to all areas of business regulation. It should be understood that the credibility, for regulatory purposes, of an entity's actions, reports and statements will be a function of its compliance with these criteria.

A company's written and actual commitment to standards of business conduct should be monitored by the regulatory authority and seen as an indicator of the extent to which reliance can be placed on the company's various compliance assurances. Companies should be required to disclose, on an annual basis, the actions they have taken to establish and administer policies and practices on standards of conduct. Those reports should include details of any specific matters, eg regulatory investigations and fines, that could be viewed as having a bearing on the company's reputation.

3.4 STANDARDS OF COMPETENCE

Companies should be expected to have appropriate skills and human resources at all levels of the business.

The responsibility of boards and directors

The directors of a company are ultimately responsible for directing and supervising the activities of the business. They should thus be sufficiently competent and experienced to perform their role. Just like regulatory authorities, company directors – both executives and non-executives – have an obligation to acquire an effective understanding of the nature of their company's business, its management structure and its various operational processes.

The level of expertise and experience appropriate for individual directors should be related to the nature, size and complexity of the business and the particular role, if any, that an individual director fulfils. Those directors who sit on specialised committees of the board, for example audit committees and remuneration committees, should similarly be expected to ensure that they are sufficiently competent and experienced to perform those particular roles. Where directors are entitled by law to delegate responsibilities in defined matters to other directors or employees, the board should still keep such delegations under review and monitor their operation so as to ensure that the directors are able to exercise effective supervision. Boards should ensure continuously that suitable training is made available to directors in respect of matters concerning the business activities of the company.

The board is also responsible for ensuring that the company, below board level, possesses adequate numbers of staff with the skills and experience that the company needs to fulfil its business objectives.

The role of the regulator

It is in the direct interests of the regulatory authority that companies comply with this principle. Companies should be expected to satisfy the authority, on a regular basis, that they do so.

3.5 CORPORATE GOVERNANCE

Boards, shareholders and stakeholders should share a common understanding of the purpose and scope of corporate governance.

In the spirit of this principle, companies should be governed by the board with the core aims of

(i) generating trust and confidence in the company, and

(ii) defending and promoting its long-term interests.

Boards need to acquire an effective understanding of the concerns of their shareholders, and where appropriate other stakeholders, and take these concerns into account in the decision-making process. Shareholders should be prepared, where practical, to play an active role in supervising the board while remembering that the responsibility of the board is to secure the long-term interests of the company as a whole and not necessarily to satisfy the short-term interests of any individual or group of investors.

The role of the board

The board of a company (and the equivalent governing body in other types of entity) is responsible for directing and controlling its affairs. It does this for the primary purpose of serving the interests of the company's owners. The board should therefore establish approaches that will help it to ensure that the company's business is being conducted successfully and that will allow it to account transparently to shareholders (and, where appropriate, regulatory authorities) for its stewardship. This will apply regardless of the size or the nature of the company.

In many countries, guidance on optimal corporate governance arrangements is the subject of legal rules, codes of practice and/or regulatory rules. Corporate governance rules and codes aim to maximise the quality of the decision-making process within a company's board. Most do this by trying to ensure that, *inter alia*:

- decision-making is not concentrated in the hands of one individual or small group
- the board is 'refreshed' by the addition of new members on a regular basis
- the board contains non-executive members, who are expected to bring an attitude of independence and objectivity to the decision-making process
- matters that are considered to be particularly sensitive, such as the company's financial reporting procedures and executive remuneration, are addressed by separate committees of the board, which contain members who are considered to meet criteria of 'independence'.

Where any such rules or codes apply, companies should comply with their requirements to the fullest practical extent. Good corporate governance should, however, involve not solely compliance with the written requirements of rules but a genuine commitment to comply with the broader spirit of good corporate governance. Merely having the requisite proportion of non-executive directors on a board, or separating the roles of chairman and CEO, is not enough in itself: the fundamental objective should be to achieve a balanced board and to avoid excessive concentration of power. One of the lessons learned from the banking crisis (and previous corporate crises) is that some companies that complied with the letter of corporate governance codes, and considered themselves to follow best practice, were not in reality well governed at all. Accordingly, companies should keep their corporate governance arrangements under constant review and consider making changes where they are called for. To assist in this, companies may consider it helpful to appoint a separate corporate governance committee of the board. Companies should, in particular, reflect on each case of governance failure they have experienced and consider why the board, or individual directors, did not ask the questions or suggest and achieve the actions that might have prevented that failure from happening.

In the same way that individual companies should keep their practices under review and re-address them in the light of failures, accepted wisdom on what amounts to good corporate governance practice should also be kept under review by the authorities. The experience of the banking crisis suggests that a review of thinking on this issue is now opportune.

Even though the appointment of non-executive directors to company boards has for many years been widely considered to be an appropriate means of challenging and overseeing the executive, the presence of non-executives on the boards of banks – and other types of company – does not appear to have succeeded in restraining irresponsible and in some cases disastrous business practices. The reasons for the cases of apparent ineffectiveness need to be explored and addressed. It may be, for example, that failures can be linked to inadequate information flow to non-executives, to lack of appropriate training or to lack of support, in which case changes will need to be made to corporate governance rules in several respects. There may also be a case for ensuring that non-executives, and boards in general, receive independent assurance about the actions of management in implementing the policies of the board, especially in respect of control matters.

Engagement with shareholders and other stakeholders

Where a company's directors are legally responsible for acting in the collective best interests of the shareholders, they should ensure that they understand what those interests are and act accordingly. It is right that the directors retain ultimate decision-making authority within a company, but taking active steps to engage effectively with them on key issues will help them to ensure that they represent the interests of their shareholders.

Shareholders collectively own the companies in which they invest. It is to them that the board is accountable and in whose name directors conduct the company's affairs. Although the traditional Anglo-Saxon model of shareholder primacy is increasingly being challenged, in the UK and in many other countries, the membership remains a key element in the governance framework of entities of all kinds.

Except in small businesses, however, few shareholders actually exercise their rights of participation: most invest for their own financial reasons and, in normal circumstances, show little interest in monitoring the management. Although the large, institutional investor groups do monitor and engage with company boards on a regular basis, the banking crisis has shown that even at the listed company level, organised shareholder groups often fail to engage with boards to the extent that they can exert beneficial influence on them and restrain them from courses of action that, in retrospect at least, should have been regarded as unwise and likely to be detrimental to shareholder interests.

Institutional investor groups often own substantial holdings in the largest companies. Although the powers available to shareholders will vary from country to country, institutional groups should be prepared to use the authority they have, by virtue of their holdings, to exert influence on company boards wherever circumstances make this appropriate. Shareholder groups of whatever kind should not seek to interfere with matters of day-to-day management. Nonetheless, it is reasonable, and helpful from a governance perspective, for institutional shareholders in particular to become involved with strategic and structural issues and to establish effective working relationships with company boards in relation to those issues.

Investors also owe it to themselves and their own stakeholders to monitor the company's actions and to challenge them where this may be appropriate.

It is not realistic to expect shareholders always to be able to take effective action to protect the value of their investments, but neither is it realistic to expect that, in all cases, external regulation will be able to do it for them. Investors should accept their own responsibility to evaluate critically plans and decisions which are likely to affect their interests directly, and act accordingly.

As long as shareholders only have rights to participate in company affairs, rather than responsibilities to do so, it will remain impractical to think that high levels of member engagement can be achieved in the case of larger companies. Nonetheless, if boards allow themselves to become disconnected from their shareholder bodies to the extent that they act in effective ignorance of members' concerns, the result may be not only a governance dysfunction but also breach of their legal duties by the directors.

The role of a company's body of shareholders should therefore be seen as an element of the governance framework that has the potential for exerting beneficial influence on board behaviour. In this light, company boards should be expected to explore ways of enhancing board-member communication with a view to facilitating active interest in the way that company affairs are being directed and controlled. For example, they should consider whether the information that is provided to members could be presented and communicated in different, more accessible ways; whether the potential of narrative statements such as the Operating and Financial Review (or similar) could be better exploited so as to meet the information needs of shareholders and others; and whether the company's annual general meeting could be structured more imaginatively. Regulatory authorities should also consider ways in which members might be actually required to participate more in the governance of their companies.

In the context of encouraging greater levels of shareholder participation, however, it must be remembered that it is for the company's directors to make the decisions about what is ultimately likely to be in the best interests of their company. Shareholders should not expect to pressurise boards into making decisions, especially financial decisions, that are motivated by their own short-term interests, and directors for their part need to be entitled and prepared to withstand such pressures if they believe they are not in the best interests of the company.

The role of the regulator

It is in the interests of the authorities that shareholders play their part in the governance process by asking the right questions and holding their boards to account. In assessing the compliance risk posed by individual companies, regulatory authorities will wish to consider whether they are governed in a way which reflects best applicable practice and which serves to engender trust and confidence on the part of their shareholders and other stakeholders. Where boards are required to take wider stakeholder interests into account in the way that they direct the affairs of their companies, the authorities should also consider this aspect when reviewing companies' governance arrangements.

Companies that are expected to implement corporate governance rules or codes of practice should comply with any associated requirement for disclosure regarding their compliance or otherwise. Compliance should be effectively monitored and enforced. This should extend not only to any requirement to make a 'comply or explain' statement but to compliance with the substance of the guidance itself: it is not reasonable to expect a company's shareholders to take action in respect of non-compliance with guidance on this issue.

As a matter of course, when directors of regulated entities leave their positions, either by resignation or otherwise, the regulatory authority concerned should consider conducting interviews with them with the objective of identifying any matters connected with their departures that might be of regulatory interest.

3.6 ACCOUNTABILITY

Companies should be expected to account for their activities transparently, thoroughly and with due regard for, as appropriate, the demands, rights and information needs of their stakeholders.

The role of financial reporting

Information on companies' financing and performance will be required to be prepared and disclosed in different ways and for different purposes. Whether the information concerned is intended to satisfy the needs of shareholders, regulatory authorities or others, the preparation and disclosure of accurate and credible financial information is essential for the effective supervision of companies' activities.

The specific requirements for the way that financial and other reports should be framed need to take account of the types of activity undertaken by the entity, its size and complexity, and the actual or perceived information needs of the likely users of the reports. It should follow that the more specialised and complex the business, and the greater its degree of economic materiality and stakeholder impact, the more extensive the disclosure and reporting requirements will need to be, if only because in such businesses the information needs of a large and disparate group of stakeholders will all need to be addressed within the same report.

The banking crisis has led to a number of criticisms about the role of financial reporting standards. The major criticism concerns the use, as mandated by the International Accounting Standards Board (IASB), of fair value accounting in the treatment of financial instruments. The argument concerns the fact that companies are required, under IASB rules, to value their financial instruments at current market prices, rather than at their historic cost values. Where current market values are substantially lower than the original cost of the assets concerned, entities have to make large write-downs on their balance sheets. In the exceptional conditions we have seen, 'market' values for particular assets may simply have ceased to exist, in which case companies are forced to resort to 'mark to model' techniques, based on the few sales that are taking place. It also means that assets that had originally been held for trading purposes now have to be retained, with any value now dependent on prospective cash flows from interest and repayments.

Where this happens, as has happened on a large scale during the banking crisis, confidence in the reporting companies will be damaged and there can be massive consequences for their capitalisation. Thus the situation under fair value rules is very different from what happens when assets are reported using the amortised cost approach, where there is no need to report write-downs unless the value of expected future cash flows is estimated to be less than historical cost. Since banks will ordinarily have very substantial holdings of financial instruments, the adoption of fair value rules has affected their results much more than it has other entities.

There is no doubt that fair value accounting has had significant effects on companies' reported results during this period and it is right that its further application to classes of assets other than those currently encompassed by the IASB rules be deferred until such time as the full ramifications of the approach can be digested. There are certainly technical issues with fair value that need to be addressed. The use of fair value accounting has not, however, been a direct cause of the crisis and its application should not be suspended. It remains the only realistic method of accounting for derivatives and has the great virtue of transparency – it discloses the value that an entity stands to gain by selling or settling the assets concerned at the balance sheet date, if it chooses to do so. It should also be noted that investor groups, whose interests annual financial statements are primarily intended to address, have been strong supporters of the use of fair value accounting.

Another, related issue that has been raised in the wake of the crisis is whether the rules governing annual financial statements should, in future, be framed so as to be consistent with the express information needs of regulatory authorities, rather than those of the company's shareholders. The meeting of the G20 countries in April 2009 expressly called on the IASB and other standard-setters to work with regulatory authorities on ways to help ensure that accounting standards serve the cause of promoting financial stability in the wider economy. Gearing financial statements so as to reflect compliance or otherwise with prudential and regulatory requirements would be a material departure and would require a fundamental re-think of the purpose of accounting. Financial statements, in their traditional form, are designed essentially to enable directors to report on their stewardship of their company to their shareholders, so as to help them make informed decisions about their investments in the company.

It would not be helpful to make a fundamental change of this kind since the information needs of investors and regulatory authorities are different and should be addressed by different routes. If regulatory authorities need different or additional financial information in order to increase the effectiveness of their own regulatory functions, changes should be made. Any specific information needs that the regulatory authorities have for their purposes, and that are not met by the general purpose financial statements in their current or any revised form, should best be addressed by means of separate and dedicated prudential reporting requirements.

The key contribution that financial reporting can make to financial stability should be seen as providing timely, neutral and transparent information to investors and others that they can trust and rely on to report economic events as they happen and describe their impact on companies, their performance and financial position. This process helps the cause of stability by helping to correct the natural pro-cyclicality of markets in over-estimating losses at times of great uncertainty, by providing the basis for more rational pricing decisions.

This is not to suggest that the financial reporting process within its existing parameters cannot develop so as to enhance the understanding of investors and others of the financial standing, performance and prospects of reporting entities.

One pressing issue in this area concerns the extent of loan loss provision by banks. Accounting standards generally are built on the reporting of losses that have been incurred, but it seems probable that regulators in the banking sector will in future expect losses to be anticipated by institutions, or else look to models adopted in Spain and elsewhere. It is worth exploring the extent to which those two approaches could be brought together. For example, has the incurred loss model been too slow in allowing losses to be recognised as the economic cycle worsened? Is there scope for going beyond this and recognising expected losses through the life of loans?

It seems likely that regulators, for prudential purposes, will wish to go further than this and develop models that require reserves to be created in the good times for losses that can be expected at worse times in the economic cycle. Should this materialise, how should such reserves be shown in financial reports – as a separate designated reserve within equity or as reductions in asset values, thus creating losses (in the good times) and profits (in the bad times)? The first of these would be the better representation of economic reality. Any additional regulatory buffers of this kind should be disclosed in banks' accounts in a transparent way, as they may provide useful insights for investors regarding the longer-term risks of different areas of lending.

Another significant issue concerns the effects of the accumulation of legal and technical reporting rules for the size and complexity of financial statements, especially those of banks. This situation is giving rise to questions about whether such statements can still serve a coherent information purpose for any class of user (and contribute to the goal of member engagement discussed elsewhere in this paper). The UK and International Accounting Standards Boards are both looking at this issue and this development is welcome.

Additionally, the profession needs to address a number of important technical questions concerning the same core issue of how to render accounting practices more transparent and useful to users. These questions include the following.

- What should be the key purpose of accounts – to reflect an accurate picture of what has happened, inform about the present, or predict the future?
- Are financial statements currently expected to do too many things, resulting in a lack of balance between understandability and transparency?
- How could accounts communicate more effective information on risk?
- Does narrative reporting as it is currently framed serve a useful purpose and if not, is there a better way of communicating non-financial information?
- Would it serve the interests of the various users of accounts if the concept of materiality was expanded so as to require financial information to be presented in ranges of probability?

These, and other key questions are for the profession to address.

The role of external audit

The process of external audit is integral to the objective of protecting the interests of a company's members and a necessary component of regulation. First and foremost, the audit process should be, and should be seen to be, objective and independent of management. Auditors should have all necessary powers available under the law to allow them to operate freely: to obtain the information they need and to carry out the procedures that are necessary for them to form their opinion on the company's financial statements. Auditors must also be free to frame their audit report, in whatever way they feel appropriate (subject to their conformity with applicable auditing standards) and to communicate any relevant concerns they have to the appropriate levels of management and governance within the client company.

External audit evolves over time as auditing standards and practices within the audit profession change and respond to developments in the business world. For example, in the current economic circumstances, auditors are likely to be spending more time on assessing a company's 'going concern' status and management's strategies on risk. Nonetheless, it is not just through the audit of financial statements and associated disclosures that auditors can contribute to the effective regulation of companies. Given the investigative nature of auditing, the auditor acquires knowledge of a company's internal controls and its business practices, which may have direct relevance to the work of a regulatory authority. One specific way of harvesting this, which has already been adopted in some countries (UK auditors are currently subject to a professional duty in this regard), is for the auditor to be given the entitlement (and/or obligation) to communicate certain information to the regulatory authority. This is information that may have a direct relevance to the efficient exercise of the authority's supervisory functions and that comes to the attention of the auditor as a consequence of the audit. In some jurisdictions, and for certain companies, such as banks, regulators may require that auditors examine specific information in a company's return to the regulator.

Auditing itself is increasingly carried out in accordance with International Standards of Auditing and, although the regulation of the financial system should aim to reflect that, there is much scope for regulators and the auditing profession to explore the potential that external audit has for adding new value to the regulatory process, whether through changes in the nature of an audit or extensions to its scope. In the course of considering how audit could be expanded, it will be essential to ensure that legitimate concerns held by auditors about liability are satisfactorily resolved.

3.7 INCENTIVES

Remuneration schemes for directors and employees should be integrated into a company's strategic plans and should be careful not to distort behaviour which could be detrimental to the long-term interests of the company; in particular, incentive schemes should be linked, primarily, to the achievement of longer-term shareholder value by the company as a whole.

The role of the board

Company boards should have the basic freedom to offer remuneration, pension and incentive packages that, in their opinion, the company can afford, are set at the financial level necessary to attract and retain individuals of the quality required and that provide bonus rewards that are fair and commensurate with performance. Yet boards also need to recognise that there may be other relevant factors with a bearing on this issue.

First, the way that incentive schemes are structured may have behavioural consequences that are not necessarily consistent with the best interests of the company. As has been seen during the banking crisis, schemes that promise high rewards for exceptional short-term performance may encourage a degree of risk-taking which, unless tightly monitored and controlled, can have adverse consequences for the company as a whole, its reputation and its long-term financial stability.

Secondly, boards need to be aware that, even where a company's shareholders have the legal right to review and comment on its remuneration practices, they usually cannot change commitments that have already been entered into, however much they disapprove of them. Where the company's interests suffer as a direct result of the board's agreed schemes, this could have adverse consequences for the future relationship between the board and the members.

In the light of this, boards could consider some or all of the following measures.

- Remuneration schemes should identify the achievement of longer-term shareholder value as the key measure of corporate success for the purpose of determining entitlement to contractual or non-contractual bonuses.

- Contractual bonus rewards should be linked expressly to a combination of individual and corporate performance; bonuses that are linked to the achievement of short-term performance targets should not be paid until the cash flow in relation to which they have been determined has been recorded by the company.

- Guaranteed bonuses, irrespective of either individual or corporate performance, should not be allowed.

- Boards should consult the company's members about their broad proposals for their incentive and bonus schemes before they are put into operation.

- When considering executive remuneration, bonus and pension levels, boards should consider whether those levels are reasonable given the company's performance and financial position and the corresponding levels that are available to the company's employees generally.

Finance-based incentive schemes should also be affected by the adoption of a corporate-wide ethics culture. The aim should be to ensure that undue pressures are not imposed on directors or staff to meet financial targets and at the same time that directors and managers do not turn a blind eye to high-risk activities that promise short-term profits but that are not sustainable. Companies should also consider, in the same context, the possibilities for using non-financial criteria in incentive schemes.

The role of the regulator

In the main, decisions about remuneration policy should rest with the company's board, which will be in the best position to decide whether its plans are affordable and in the company's interests. The levels of remuneration and bonuses paid by a company should be a matter of concern to the regulatory authority only to the extent that they have an inherent potential to distort the business practices of the company or any of its directors or employees and thereby threaten the longer-term stability of the company (and the interests of its shareholders and other stakeholders). The authorities should also keep under review the extent to which their own rules, such as quarterly reporting requirements, have a bearing on short-termist pressures on remuneration. They should further consider the pressures that fund managers and market analysts may exert on companies in relation to the time-scales linked to incentive awards, and whether such pressures are detrimental to the achievement of regulatory objectives.

3.8 RISK MANAGEMENT AND INTERNAL CONTROL

All companies should set up risk management and internal controls and these should be capable of being objectively challenged by the board, independently of line management.

Companies should be expected to implement procedures that enable them to identify and manage the various financial and non-financial risks that they face, that help ensure the integrity of their financial systems and that they can use to monitor with confidence the effectiveness of their various corporate policies and practices. These procedures will include those relating to the stress testing of the company's business models.

The role of the board

Company boards are responsible for setting the company's policies on risk management and internal controls and for exercising effective oversight over their practical operation by management. The board should also be aware of and understand the design of any other internal control requirements and should ensure that the effectiveness of policies and practices can be monitored with confidence.

Boards are responsible for planning and directing the company's affairs in a way which takes fully into account the various factors that will have a bearing on its business performance and the long-term interests of its shareholders. The management of business risk should be a concern for the board as whole. The board should ensure that all material risks to the company, and threats to its compliance with the law and regulatory requirements, are brought to their attention.

Internal audit

The internal audit function performs a vital function in large entities in that it provides the board, and especially the audit committee, with expert advice on how the company's controls are operating in practice. It is important, however, that the internal audit function is both objective and independent. To ensure its independence, the internal auditor should not have any line or management responsibilities and should be clearly separate from the risk management function. The scope of the internal audit function should include consideration of the risk management function and of the board's oversight of risk.

To be able to perform the role effectively, the internal auditor should have a senior status within the company. It should also be clear that the head of internal audit is not subject to management control in the exercise of their functions: the post-holder should report to the chairman of the audit committee (or equivalent) rather than an executive manager. Boards, and regulatory authorities, should consider whether the independence of the internal auditor can be enhanced by removing the costs of the internal audit function, including remuneration, from management control and transferring them to the direct control of the board.

Risk management

Risk is a constant, though constantly changing, feature of the business environment. Every business, when considering its business plans, is likely to see both threats and opportunities. Risk management involves taking appropriate defensive or evasive action in respect of the threats identified and making considered judgements about how to exploit opportunities without over-exposing the company to the risk of failure.

The banking crisis is evidence, however, that even in companies that appear to have highly sophisticated risk management systems, major failings can occur. It seems that those banks that financed their businesses heavily in the mortgage-backed securities that fuelled the sub-prime collapse did not understand the risks they were taking, made assumptions that subsequently proved to be unwise, or were prepared to take huge gambles.

No single failing appears to have been present but a number of alternative explanations suggest themselves. The tools with which company boards assessed the associated risk may not have been appropriate; boards did not devote sufficient time or resources to assessing the risk, or did not have sufficient expertise to do so properly; companies may have convinced themselves that since the same practices were being carried out by other market participants any risk that had been identified could be disregarded or downplayed. It was also the case that many boards considered that they were effectively managing risk by transferring the risk of mortgage-backed securities to the buyers of those securities (which were often AAA rated). It is fair to acknowledge, first, that neither central bank regulators nor experienced risk managers anticipated the sudden freezing up of the wholesale markets that occurred and, secondly, that external risk is harder to predict and mitigate than internal risk.

The experience of the banking crisis shows how important it is that a company's risk management and control policies and practices can be understood by the board as a whole and can be challenged, independently of management. It is important that means are developed for boards to receive 360° assurance, independent of management, that all the policies of the board are being implemented by management and that there are no major risks, known or unknown to management, that affect the company in the future. Strengthened, independent internal audit functions have a substantial role to play in achieving this outcome.

Companies should ensure that they put in place internal procedures to monitor and manage risk that are sufficient to give this function real influence and authority. Risk should remain ultimately a matter for the board as a whole, but larger companies should consider appointing a director with specific responsibility for risk and establishing a dedicated risk committee of the board.

Transparency

For boards and audit committees to perform their functions effectively, they need to have access to all information that is relevant and material to the decision-making process. In practice, this issue is very difficult to manage: boards and committees may not necessarily know whether they need the information they are given, or whether there is other, and more accurate information available that they do actually need. They are thus dependent to a great extent on the management and information structures that they set up, and on the individuals working within those structures. Accordingly, as well as establishing the structures, boards should also be prepared to insist that the flow of information to them is accurate and complete (in the sense that it does not deliberately omit or misrepresent relevant facts or possible outcomes). Boards should expect that management will perform this function professionally and ethically and with due regard to the position of the directors. Steps must be taken, in particular, to avoid any situation where one or two executives effectively control the information flow to the board.

Further, companies should adopt a practice of encouraging the communication of material information regarding the failure of controls to a specified individual or individuals within the company, such as the internal auditor. Employees within the organisation who, in good faith, bring forward information under these procedures about known or suspected failures or non-compliance with the law or regulatory rules and principles should not suffer any detriment as a result of doing so.

The role of the regulator

Strong and efficient internal control and risk management systems are essential to engender confidence in a company and the quality of its decision-making processes. If its systems are weak or if the directors are making decisions based on inadequate or incomplete information, this may serve to undermine the wider credibility of the company, including its financial reporting systems. For these reasons the regulatory authorities have a legitimate interest in ensuring that these aspects of management are treated seriously by regulated entities on a continuous basis. Regulatory authorities should consider whether they should identify risk as a separate and dedicated function, which should be managed by a special committee of the board of directors.

3.9 FUNDING

Companies in the financial sector should be required to have capital structures and levels of liquidity that correspond to the scale and the level of risk inherent in their activities and that make reasonable provision for changes in economic circumstances.

One of the main regulatory weaknesses that led to the banking crisis was the inability of the prevailing capital and liquidity regimes to restrain banks from engaging in excessively risky commercial practices, behaviour that resulted in huge losses to shareholders and, in some cases, depositors. These weaknesses need urgently to be addressed and resolved.

The various reasons for the crisis, and the policy and operational responses that should follow, are currently being considered both at the national and international level. With a financial system that is so internationalised and interconnected, it is essential that solutions be found that are both flexible and capable of being implemented, where justified, on a consistent, international level.

Current international banking regulatory standards, as set out in the Basel 2 agreement, stress the significance of risk in determining the level of capital regulation to which individual banks should be subjected. The element of risk should remain a significant consideration governing this matter. Yet the financial crisis has shown that internal and market disciplines are not sufficient to influence the banks to protect their own interests. Accordingly there is a need for better regulation in this area. Banks need to be subjected to capital requirements that are sufficient to enable them to absorb losses in the short-term without restraining their ability to lend to market participants, and that also operate as a restraint on risky commercial practices.

International regulators should adopt a coordinated approach to the definition of optimal capital levels for the major retail banks. Imposing higher capital requirements than those that apply currently could be expensive for the banks themselves and may have at least short-term implications for the availability and cost of funds to borrowers. Stringent new capital requirements will also have implications for the work of regulators and for regulatory costs. The scale of the economic consequences of the global banking crisis has been such, however, that the priority should be to achieve stability in the banking sector with the aim of avoiding future bank defaults and safeguarding the wider interests of the global economy.

As an integral part of any new regime on capital requirements, the system of regulation needs to build in safeguards that will help protect against future repetition of boom and bust cycles. Banks should be expected to comply with requirements regarding capital 'buffers', which have the effect of increasing reserves during periods of economic success and reducing expected levels during periods of decline. The aim should be to help ensure that major shocks to individual banks and the banking system as a whole do not lead to a global crisis like the one that we have recently experienced.

Regulators should consider imposing on banks a cyclical reserve requirement based on the difference between expected loss and incurred loss. It would then fall to be determined whether such a reserve was to count formally as capital or not. One option would be to create a new, contracyclical pillar requirement in the Basel 2 framework. Alternatively, the cyclical buffer could constitute a regulatory 'reserve' amounting to the first 'buffer' against provisions. It should, however, be borne in mind that the frontloading of loss recognition would not remove volatility and cyclicality since expected losses during downturns can always be expected to be higher than during upturns, and the average duration of most loan portfolios is shorter than the economic cycle.

Given that problems of liquidity have proved to be at least as acute as those of deficiencies in capital, regulatory authorities need to pay more attention to the assessment of banks' liquidity resources. There needs to be a coordinated approach to determining the most appropriate measure(s) for performing this task. Whatever measure is arrived at should still allow regulators to take into account the liquidity risks of individual banks.

Another feature of the banking crisis that calls for an appropriate regulatory response has been the accelerated blurring of the traditional distinction between retail and investment banking. This process has made it difficult for the banks themselves to exert effective control over, and has at the same time caused significant problems for regulators. It should therefore be considered whether a separation of the two types of business can and should become a long-term regulatory objective. If such an approach were adopted, retail banks would be separated from other financial institutions in terms of the activities in which they were entitled to engage. Any new product that did not resemble a loan or a deposit to an individual or a company would be presumed to be a non-retail product and not permitted to be traded by a retail bank. Regulatory bodies in the banking sector should consider the merits and the feasibility of adopting a regulatory goal of this nature to address the issue referred to.

4. Conclusion

Confidence is crucial to the effective operation of the capital and financial markets. To a degree, this vital element can be provided by the overall health of the economy. But it cannot exist on a sustainable basis unless:

(a) market participants are satisfied that all are playing by the same rules

(b) the rules that companies are expected to follow strike the right balance between facilitating business activity and adequately safeguarding stakeholder interests, and

(c) effective mechanisms are in place to ensure that those rules are complied with in practice.

The global financial crisis has revealed major flaws in each of these criteria and these now stand to be addressed by governments and regulatory authorities around the world.

This paper does not purport to be an exhaustive account of the regulatory failures that have occurred or of the remedial steps that authorities in different countries should now take. It does argue that simply by responding to the apparently lax regulatory controls of the past by increasing the regulatory burden on companies in the future will not necessarily or automatically result in improvements in either corporate responsibility or stakeholder protection. What is needed, rather, is an approach which focuses on securing the active engagement of regulated entities in the process of regulation and their active support for its declared objectives: these outcomes may not be achievable under regimes that are ostensibly either 'light' or 'heavy' touch.

The paper also stresses that there are a number of key strands to the achievement of the overall goal of inspiring confidence through better regulation and each of these must be addressed within the context of the overall regulatory response. We have indicated that particular attention needs to be paid to:

(1) the reasons for the failures in corporate governance and risk management (and how these can be remedied)

(2) the possible additional contribution that the external auditor might make to the regulatory process, and

(3) in light of the moves to achieve greater international coordination, the extent to which individual regulatory authorities should remain free to follow their own supervisory and regulatory practices.

As the paper acknowledges, explanations for and solutions to the recent crisis are being put forward from many sources, government and private alike. We are encouraged that many of the ideas put forward in this paper coincide with recommendations being made elsewhere. For example, the US Treasury White Paper *Financial Regulatory Reform*, published in June 2009, stresses, as key causes of the crisis, the failure of risk management systems to keep pace with the complexity of new financial products and gaps and weaknesses in the supervision of firms by regulatory authorities. More broadly the US proposals recognise the need for a regulatory system which is simpler but more effectively enforced, and which is also able to adapt and evolve with changes in the financial market. In the UK, the governor of the Bank of England has echoed the point made by ACCA about the need for governments and regulatory authorities to guard against allowing elements within the financial system to become so large that they cannot be effectively regulated. The communiqué issued by the G20 meeting of government finance ministers in April 2009 also repeated our call for the adoption of ethics-based corporate cultures by emphasising that strengthened regulation and supervision must promote propriety, integrity and transparency.

ACCA would welcome comments on this report and looks forward to contributing further to the current international debate. Comments may be sent to:

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Quotes

1. 'We are becoming more of a bloodhound than a watchdog. There is much more emphasis from auditors on risk than 10 years ago. Company management has now to give good explanations of their risk profile and risk strategies and we quiz them on that. But you can't do an audit if you assume the client is a crook.'
Richard Sun, consumer and industrial products leader, PwC, Hong Kong SAR

2. 'The FSA's Statutory Objectives look tired. My suggestions would be: Consumer protection (to include consumer awareness and the prevention of financial crime; (both unchanged); financial stability (to be carried out in conjunction with the central bank's financial system responsibilities); and the encouragement and maintenance of financial competition. These would be appropriate objectives for a financial services regulator.'
David Clark, bank director and former senior adviser to the Financial Services Authority, the UK's City regulator

3. 'If you concentrate on the offshore banking system and tax havens, and bring 80% of that back into mainstream regulation that will be a major step. The regulators did not see the pressure building up for outrageous returns because so much activity was conducted via shadow banking.'
Philippe Danjou, International Accounting Standards Board, and former director of AMF, the French securities regulator

4. 'The complexity and highly technical nature of the new products pose difficulties for regulators and non-executive directors under current circumstances. However it cannot be an excuse for non-regulation or ineffective supervision. These days a typical problem of the regulators and NEDs is that they are too far from the banking industry.'
Edgar Zhi, CFO, RBS Bank, Shanghai

5. 'I am convinced that the financial system will be moving to the more traditional banking models and that there is going to be a natural aversion to risk taking associated with complex products. So this issue will be partly solved by market forces, however, the regulators will need to ensure that they fully understand the products used by the entities they supervise and they will need to make sure that at least a similar level of knowledge is shared by the bank boards.'
Petr Kriz FCCA, PwC assurance partner, Czech Republic

6. 'The success of any regulatory regime is the ability to protect ordinary investors/customers' interests before an unpredictable man-made disaster happens. In this sense, regulators should be concerned about going concern, guarantee funds, modest bonuses for management, adequate capital, better organizational citizenship for employees, community and customers.'
US financial regulator (name withheld)

7. 'There is no substitute for a program of on-site inspections at regular intervals with a reasonable level of transaction testing and interaction with operating staff. Only then can a regulator determine what is the best method of monitoring and supervising. Whether this results in a 'light-touch' or a more intrusive interventionist approach depends on the findings of the regulator in respect of business, products and systems and controls. Associating 'light-touch' regulation with 'principles-based' and 'intrusive' or 'close monitoring' with 'rules-based' is misleading. Those terms are not mutually exclusive. Regulators employ a mixture of rules and principles to regulate financial firms. While firms desire certainty, they also appreciate a business environment where they have the flexibility to react quickly to market conditions. Principles lend themselves more easily to this whereas rules can take a while to change.'
Dubai Financial Services Authority (DFSA)

8. 'Companies are legally structured so that company boards act in the best interests of the ordinary shareholders. However, executive management have almost always placed their own interests first, resulting in insufficient regard for the longer term consequences of their actions to the ordinary shareholders and other stakeholders. A better model for a banking institution might be a stakeholder model, one where the risks and rewards are better shared among the contributors of its funds – the ordinary shareholders, the preferred shareholders, bondholders and depositors.'
Jeremy Hoon, financial services partner, KPMG Singapore

9. 'Corporate governance should be practised in greater levels of strictness. In South Africa, we went through King 1 and 2 and now the advent of King 3. Supervisory boards and non-executive need all the help they can get from a regulation perspective (like King 3) and the Johannesburg Stock Exchange requirements in terms of regulation. Activities in retail and investment banking are aggressive, and are often driven by profit targets. This creates a fertile ground for possible irregular practices and the resultant possible breach of ethical conduct.'
Raj Mahabeer, CFO, Auditor General's Office, South Africa

10. 'I believe that regulators will always be behind market forces, as the desire to innovate and make profits will always exceed regulatory capacity. But regulators need to look more at risk – both institutions' business risks and the systematic risk those companies represent – to adjust their approach. Auditors too need to assess more forward-looking risk information and not just financial statements. Accounts are important but out of date.'
David Wu FCCA, PwC assurance partner, Beijing and ACCA Council member

Contributors to paper

INTERVIEWEES

Richard Sun, consumer and industrial products leader, PwC, Hong Kong SAR

Philippe Danjou, International Accounting Standards Board, and former director of AMF, the French securities regulator (speaking in a personal capacity)

Edgar Zhi, CFO, RBS Bank, Shanghai

Petr Kriz FCCA, PwC assurance partner, Czech Republic

Jeremy Hoon, financial services partner, KPMG Singapore

Raj Mahabeer, CFO, Auditor General's Office, South Africa

David Wu FCCA, PwC assurance partner, Beijing and ACCA Council member

Sun Yong, assurance partner, Grant Thornton, Shanghai

Interviews were also held with a senior representative of the Financial Services Authority (FSA) in the UK, a representative of the Dubai Financial Services Authority (DFSA), a partner in a Big Four firm in Dubai and a New York-based financial regulator, who preferred not to be individually named.

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