The Future of Financial Regulation
An Update

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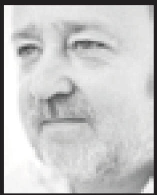
ACCA (the Association of Chartered Certified Accountants) is the global body for professional accountants. We support our 131,500 members and 362,000 students throughout their careers, providing services through a network of 80 offices and centres. Our focus is on professional values, ethics and governance, 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



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

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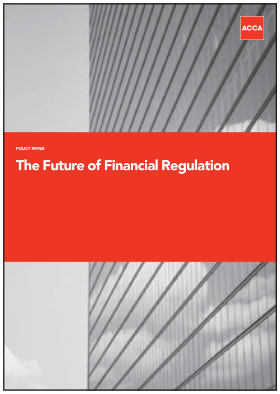

In June 2009, ACCA published a policy paper, *The Future of Financial Regulation,*[1] to analyse the range of factors which contributed to the financial crisis and to set out a number of principles which, we believe, should play a central part in the design and implementation of any effective regulatory framework.

The paper, intended to serve as a contribution to the on-going debate on the consequences of the financial crisis, featured input from many senior figures from the finance industry and accountancy profession. This input was provided in two ways: firstly, via a special round table meeting held in London in April 2009, which was attended by a specially invited group of experts, and secondly via a series of focused interviews conducted with bankers, regulators, standard-setters, practitioners and businesspeople in Europe, North America, the Middle East, Asia-Pacific and Africa. In keeping with the approach adopted, the aim of the project was not only to take a wide-ranging look at the contributory causes of the banking crisis but to reflect a similarly broad geographical spread of views on what should be the way forward.

The ACCA paper argued that, while there appeared to have been failures in the way that institutions in the financial sector had been regulated and supervised by the relevant authorities, addressing and resolving those structural failings should not be seen as the sole route towards resolving the current crisis.

The credit crunch was, we argued, more a failing of governance and ethics than of regulation *per se*, and accordingly, it would be a mistake to think that making changes to the mechanics and structure of regulation would by itself resolve the situation.

The efforts to reconstruct the regulatory environment should address all relevant factors, including the lack of competition in the banking sector, the position of the shadow banking sector and the role of government policy in market activity. But these efforts should accept the inherent limits of what any external regulatory process can hope to achieve and should aim, where appropriate, to encourage an element of self-regulation by increasing the onus on regulated entities to adopt ethical corporate cultures and improve their corporate governance practices.

The paper also suggested that, whatever the exact future shape of financial sector regulation, the structure needs to be designed not solely with a view to rectifying the problems of the past but with a view to pre-empting the so far unknown problems of the future. In this light, ACCA argued that any new approach to regulation should not be so rigid, and so focused on dealing with known threats of the kind we have seen recently, that it would be insufficiently flexible to be able to respond to the new threats that will undoubtedly emerge in the future.

This paper considers some of the myriad developments that have taken place since June 2009 and relates them to the conclusions and recommendations made in *The Future of Financial Regulation*.

1. http://www.accaglobal.com/pubs/general/activities/library/governance/cg_pubs/tech-tp-ffr.pdf

Recent developments – a quick summary

Since we published our paper in June 2009, the pace of regulatory activity has continued undiminished.

As the ACCA report came out, a landmark US Treasury paper, *Financial Regulatory Reform,* was published, which recommended a major overhaul of the US regulatory structure, involving boosting the powers of the Federal Reserve to take on a system atic risk role. This immediately raised concerns that the traditional independence of the central bank from government could be compromised by such a change.

At the same time, in the UK, a Government White Paper on regulation made proposals on matters such as governance, competition and consumer protection. This was followed in July by the commission by the Government of Sir David Walker's review of corporate governance in banks and a review by the Financial Reporting Council of the Combined Code on corporate governance. Then in October we saw the publication of a discussion paper by the Financial Services Authority (FSA) which examined the issue of systemically important, so-called 'too big to fail' banks. Accompanying that paper was a highly public and on-going debate, engaged in by senior banking figures, over whether extra capital requirements and regulatory supervision were sufficient to deal with those institutions or whether more radical measures were needed to break them up. And in November the UK Government promised to bring in new legislation which would give tough new enforcement powers to the FSA.

In September, the European Commission published its own ambitious proposals for overhauling the regulation of the financial sector throughout the EU. This would entail setting up two new structures for macro- and micro-level supervision of the sector. At a global level, the G20 summit in Pittsburgh committed governments to develop internationally agreed rules on leverage and capital, in addition to reiterating the need for a global set of accounting rules. In November, some of the UK's high street banks, which had been given large injections of taxpayers' money, were also ordered by European authorities to be broken up to avoid contravening competition rules. And a Bill was presented to the US Congress which would go much further than the June plans backed by the US Treasury and set up a 'super regulator' – The Financial Institutions Regulatory Administration – to take on much of the work of the existing regulators. Under this plan, put forward by Senator Chris Dodd, the Federal Reserve would return to focusing on monetary policy. The Fed has retorted that its ability to create effective monetary policy relied heavily on its role as a bank regulator. That debate clearly has some way to run.

The principles set out in *The Future of Financial Regulation*, together with key conclusions from our analysis of the financial crisis, are summarised on the following pages, with commentary on the extent to which those issues appear to be being addressed by governments and regulatory bodies.

1. The purpose of regulation

There needs to be a clear understanding amongst all parties of the purpose of regulation. This should be to facilitate legitimate business activity while providing essential safeguards for the interests of stakeholders and ensuring fair competition in the market. Whether the approach taken can be characterised as 'light-touch' or 'intrusive', there must be effective communication and agreement on the principles between regulator and regulated. ACCA also prefers a principles-based approach to regulation, with a strong emphasis on ethical practices at its heart, rather than one centred on extensive rules.

ACCA made these points to try to encourage policy makers to ensure that their response to the banking crisis did not lead to a wholesale re-direction of regulatory practices, away from the 'light touch' approach (which had been officially sanctioned by many governments in the years before the crisis) and towards a much more heavy handed and bureaucratic approach, solely because the former approach was considered to be discredited because of the crisis. Our thinking, in making these points, was influenced by the experience of the US in the period immediately following the accounting scandals involving Enron et al in the early 2000s – the resulting Sarbanes–Oxley Act imposed very stringent and rigid obligations on US companies, obligations which were subsequently acknowledged by the US authorities to be excessive and counter-productive.

We remain of the view that the process of framing any new regulatory architecture should first of all be clear about what the process is intended to achieve and then design it so as to give it the best chance of succeeding. A crucial element in good regulation is the establishment of an effective 'connect' between regulatory authorities and the businesses that they regulate. Contributors to our June paper made the point that, just as regulators need to understand the businesses that they are regulating, so the businesses themselves need to understand clearly what it is that the regulators are trying to do. Effective regulation should be locally-focused – Philippe Danjou, a former director of the French securities regulator, the Autorité des Marchés Financiers, and currently a member of the International Accounting Standards Board (IASB) said that an effective regulator should be like a trusted policeman knowing his 'beat' and understanding the characters and issues he encountered and how best to deal with them quickly and efficiently. In this way the existence of effective supervision would help ensure good conduct on a voluntary basis.

With reference to the new regulatory architecture being proposed for the EU (discussed below), we fear that if the real source of regulatory authority comes to be seen as too remote from the regulated community, the element of 'connect' will be lost and it will become more difficult to establish any mutually beneficial relationship of willing compliance.

Further, we consider that the proposed new regulatory structure in the EU should aim to strike a sensible balance between achieving appropriate levels of co-ordination and allowing a reasonable amount of flexibility, subject to adherence to broad regulatory principles. The danger of imposing too many detailed rules is, always, that some businesses may seek to avoid them or else comply with their letter but not their spirit. Thus the design of the regulatory system should aim to avoid that undesirable outcome.

Ultimately, though, any new regulatory process needs to earn the confidence of those individuals and businesses who use the banking system. In our June paper, we referred specifically to the importance of banks acknowledging their obligations to depositors, as a means of helping to restore consumer confidence in the banking industry. In this connection we note that legislation currently before the US Congress would impose on banking institutions a fiduciary duty to their depositors. We believe this measure would serve as a strong structural discipline for banks and a strong additional incentive for them to pursue responsible practices on risk management. We also believe that governments and regulators need to address urgently the need to make available strong and effective means of redress for consumers who have been failed by the banking system: the proposed creation in the US of a new consumer financial protection agency is a development that we would encourage others to consider.

2. The structure of regulation

Regulators should adopt a systemic approach to the safeguarding of stakeholder interests, taking wider macro-economic factors into account. The activities of any specialised entities which are outside the regulatory net should be reviewed and if necessary be brought into its scope.

In recent months we have seen extensive efforts, at both the European level and the wider international level, to establish new structures designed to monitor developing threats to the financial system and to inform the work of supervisors at the micro-level.

The Financial Stability Board (FSB) was established through the auspices of G20 in April 2009 as an expert group to monitor economic threats at the global level.

The EU, meanwhile, is currently proposing the creation of a two-tier regulatory structure in Europe. This will entail, at the macro-level, a new European Systemic Risk Board (ESRB), to comprise members of the European Central Bank and central bank governors of each EU member state. Both the FSB and the ESRB will be responsible for identifying threats to financial stability in the macro-economic environment, such as asset bubbles. It was the lack of any such bodies to co-ordinate international responses to growing structural problems that undoubtedly contributed to the huge macro-imbalances that built up during the credit boom of 1997–2007. We therefore welcome the establishment of these structures and trust that the ESRB will work constructively both with the new FSB and with the various regulatory authorities at the national level.

The second stage of the proposed EU regulatory structure is intended to enhance the level of co-ordination and co-operation between the national supervisory bodies. A new European Banking Authority would have the power to issue standards and guidelines which national authorities would be expected to follow, and in the case of any failure to comply with those standards, or dispute as to their interpretation, the new Authority would have power to investigate and issue binding directions. Hence the intention is to enhance and standardise levels of cross-border supervisory practices.

ACCA supports, in principle, the idea of harmonising regulatory standards. There is an obvious danger in allowing the existence of regulatory arbitrage where companies can opt to situate themselves in countries which boast the most lax regulatory standards. And we are pleased that responsibility for supervising national firms will remain at the national level and that there is no longer any suggestion to create any sort of ‘international super-regulator’.

As stated above, however, we think there is a potential danger in allowing regulatory and supervisory structures to become too far detached from the businesses that they regulate. Another potential danger we foresee is that, by standardising regulatory rules at the EU level, individual countries and regulatory authorities will lose the ability to devise their own regulatory approaches. It will be remembered that the authorities in Spain were able to protect their banks from the worst consequences of the financial crisis because of their own, independently devised capital requirements: any new procedures should ideally contain the flexibility to ensure that different or radical prudential approaches are able to be considered and accommodated. It has also been argued that France, too, suffered less than other countries because of tighter regulation on capitalisation than was required by international standards, and also because of the traditionally cautious lending practices of French banks. Canada and Australia also suffered relatively mildly from the credit crunch largely because of the more conservative approach of their banks.

There is currently a fierce political debate going on in several countries, including the UK and the US, about whether the role of the central bank should be enhanced so as to take on prudential regulation of systemic risk or whether this function should be carried out by a separate regulator. ACCA does not enter into this particular debate though would agree that the central bank is well-positioned to monitor systemic risk. But whichever system is chosen, it is crucial that the identity of the lead regulator be clearly understood by all parties and that the chosen body has the necessary powers and authority to carry out this role effectively.

3. Competition

Governments and national and regional authorities should regard the promotion of healthy competition in the market place as being crucial to the enhancement of the potential effectiveness of their regulatory systems. 'Too big to fail' institutions are anathema to good regulation. One means of addressing this issue would be to consider separating wholesale and retail banking activities.

Of all the areas of concern identified in the June paper, it is perhaps competition which has been at the top of the agenda for governments and regulators in recent months. Earlier in the year, the Turner report in the UK and the EU-sponsored de Larosière report both rightly identified that no adequate way had yet been found of regulating so-called Large Complex Financial Institutions (LCFIs), which have now become better known as 'too big to fail' entities. It is fair to conclude that this crucial question still remains unanswered, although the US Treasury Bill seeks to put the cost for any potential failure of an LCFI onto other financial institutions rather than the taxpayer. The idea is that a big enough levy on these firms will allow monoliths like Lehmans to fail without public bailout, which would in theory lead to more effective regulation.

There appears at least to be general international agreement that the creation of LCFIs has proved, in retrospect, to be an undesirable development, damaging both to competition and the cause of efficient regulation. The build-up of a small number of vast institutions has been by nature anti-competitive, allowing them to charge what many believe are excessive fees for basic investment banking transactions.

The UK Government White Paper issued in late June 2009, while sound in many respects, notably its emphasis on the importance of reforming bank governance and increasing consumer and depositor protection was, perhaps, a little weak on the issue of competition and how to deal with LCFIs. Since then, however, global focus has centred on this issue. But the debate has become polarised between those who call for the forced break-up of LCFIs, with a clear division between investment and retail banking, and those, such as the UK Government and the FSA, who oppose this view as being simplistic and who prefer to rely instead on the dual approach of more intrusive regulatory supervision of LCFIs plus the imposition of extra capital requirements to prevent future crises.

ACCA is attracted to the idea of re-introducing of a form of the *Glass–Steagall Act.* Its principles are sound because it ensures clarity of purpose on what regulation is intended to achieve and puts consumer protection first. Given the collapse of confidence in financial institutions, any measure which reassures consumers must be supported. It is true that complete separation of investment from retail might be impossible – even under a 'narrow banking' scenario deposit-taking banks would have to be allowed a degree of securitisation, for example over mortgages – but an effective segmentation between the two activities must be the aim. As Mervyn King, governor of the Bank of England, said recently in the context of a UK debate on this issue 'it is hard to see why' such separation is impractical.

King also pointed out that increasing capital requirements on banks is no guarantee of creating a safety cushion large enough to prevent further calls on taxpayer funds. This is true, and it should also be remembered that every increase in capital being held by banks potentially represents thwarted lending to credit-starved businesses. ACCA would, however, support a form of 'systemic risk surcharge' for larger institutions and micro-regulation of LCFIs. Targeted regulation and supervision must be better than a 'one-size fits all' approach.

We would also agree with the FSA's proposals of a 'living will' for systemically important banks, under which they would be obliged to produce recovery and resolution plans in the event of catastrophe. The Lehmans episode has shown the difficulties facing administrators who have to deal with different insolvency regimes in different countries while sorting out the affairs of one firm. We also commend their focus on the need to 'assess the possible cumulative impact of multiple reforms to capital and liquidity regimes now being considered by international standard-setting bodies'. It is essential that there is proper co-ordination between national, international and regional regulators to avoid either overload or arbitrage. This point was made forcibly in the Pittsburgh G20 communique in September 2009.

4. Standards of business conduct

Companies should be expected to carry out their activities in accordance with high standards of business conduct. Regulatory authorities should encourage the adoption in financial institutions of ethics-based corporate cultures.

The G20 meeting in April 2009 agreed that 'strengthened regulation and supervision must promote propriety, integrity and transparency'. We concur with that statement, which was re-affirmed at Pittsburgh in September.

In the UK, the FSA has, in recent months, been intensifying its practice of interviewing senior officials before they take up their posts in UK financial institutions. And in November this year it announced that it planned to explore further steps to ensure that institutions, at the highest levels, adopt ethical frameworks and corporate cultures which learn from the mistakes of the past and which are conducive to responsible commercial conduct.

We believe that both these initiatives are much to be encouraged as they are consistent with the broad policy line taken by G20 and quoted above. We reiterate the point we made in the June paper, to the effect that if companies are encouraged to regulate themselves, by (in part) recognising and observing core standards of business conduct, then this will not only enhance the credibility of the information provided to the supervisory authorities but will serve the purpose of protecting the interests of stakeholders as well.

But, overall, we consider that this area is one which calls for more regulatory attention in the months to come.

5. Standards of competence

Companies should be expected to have appropriate skills and human resources at all levels of the business. Regulatory authorities should take reasonable steps to ensure regulated entities have the necessary expertise to comply with regulatory requirements and to protect their interests of their shareholders. The authorities too must have sufficient resources to ensure the market knowledge and skills of their staff are fit for purpose.

In the UK, the Walker review of corporate governance in banks, discussed more fully below, has addressed the issue of competence, especially in relation to non-executive directors, and concluded that the specific demands of the banking sector should oblige directors to be able to demonstrate a high level of knowledge and experience of the sector as a condition of holding office. We welcome this finding, on the ground that a recurring feature of the crisis was the succession of reports that non-executive directors (and executives as well) felt unable to understand the highly complicated nature of the products which their companies were devising and trading. If they were unable to understand the products, then that would have contributed directly to their inability to understand the level of risk inherent in those products.

We would refer also to research published earlier this year by Nestor Advisors, a London consultancy firm, which found that all the best performing banks in its survey were chaired by individuals with strong industry experience (and, conversely, the worst performing banks in the sample were chaired by persons without industry experience). We should remember, however, that raising skill levels among directors will not resolve the problem of failure to understand complex products so long as those products continue to become ever more complex and convoluted.

Regarding the need for regulatory authorities to have staff with adequate skills and experience, this will inevitably remain a difficult problem for the authorities as long as the levels of remuneration they can offer lag far behind those able to be offered by the institutions themselves. We do not under-estimate the difficulty inherent in this matter but the point needs to be re-stated that in order to exercise effective supervision over financial institutions, the authorities need to be able to understand market practices thoroughly as they evolve.

6. Corporate governance

Boards, shareholders and, where appropriate, other stakeholders should have a common understanding of the purpose and scope of corporate governance. The financial crisis has highlighted a number of serious weaknesses in governance even among companies which followed official guidance and codes, and these need to be addressed. Specifically, there should be a specific review of the role of non-executive directors (NEDs) and how they can be made more effective in supervising executives in large complex institutions.

In the UK, the Walker review followed the widespread criticisms of governance failings in the run up to the banking crisis and subsequently. On the basis of the review's preliminary findings, Walker has done a good job in terms of analysing the root cause of governance failings – which ACCA has long argued were the single most important cause of the financial crisis. But its limited terms of reference meant his report was unable to assess the fundamental issue of lack of competition in the banking sector. As we have seen, the concentration of power among a small number of huge entities has prevented proper competition and it is this which has actively contributed to factors such as the paying of excessive fees and bonuses.

Walker was likely, in his final report and recommendations, due in December 2009, to argue that non-executive directors should be prepared to make a substantial minimum time commitment to carrying out their functions: this was likely to be set at 30 working days a year. As indicated above, Walker was also expected to argue that non-executive directors of specialised businesses such as banks should be expected to fulfil a higher standard of knowledge and experience of the sector than is usual for company directors. The review of the UK's combined code on corporate governance, which is also on-going at the time of writing, also invited commentators to focus on, *inter alia*, the quality of support and information available to the board and its committees.

ACCA welcomes the attention being given to all of these important issues and looks forward to progress being made on a number of specific matters. But we believe that there remains much to do to fulfil the potential of NEDs to exercise meaningful and effective supervision over the actions of executives. One particular area where we consider that NEDs need more help concerns the obtaining of assurance that policies which have been agreed at board level have actually been complied with and put into action by the company's management. And at the regulatory level, we continue to hold the view that more needs to be done regarding enforcement, since it is unrealistic to expect shareholders generally to be sufficiently organised, informed and committed to hold their companies to account for governance compliance failures.

We would also make the point that governance problems can sometimes be associated more with a lack of appropriate behaviour and values at senior levels than with deficiencies in rules or governance code provisions. For this reason we consider that good corporate governance is not simply a question of complying with the letter of written rules – it is also about having the commitment, right from the top of an organisation, to supporting the spirit and aims of good governance. This point cross-refers to the point we make in section 4 'Standards of business conduct'.

7. 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 accountancy profession should consider ways of making the processes of financial reporting and auditing more useful to stakeholders, with specific focus on enhancing reporting on risk.

The main issues currently at stake in this context are, firstly, the technical rules governing how financial instruments are accounted for, and secondly whether the processes of financial reporting continue to meet the needs of their stakeholders.

On the first matter, the G20 in September 2009 called on the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) to work together to create a single set of global standards and to complete their convergence project by June 2011. ACCA supports this objective and believes that the leading standard-setting bodies should co-ordinate their efforts so as to achieve the goal set by the G20.

Our view remains that the use of fair value accounting did not in itself cause the crisis and that the disclosures required by the accounting rules are fundamentally consistent with the aim of providing transparent information about business activities to the markets. A significant virtue of the rules has been that the underlying problems of the sector have been revealed so fully and quickly.

In recent months ACCA has, however, been critical of the decision of the US standard-setter to bring forward amended rules on the use of fair value accounting so as to relax the circumstances in which companies are obliged to use fair value techniques. This new guidance has appeared to be inconsistent with the guidance contained in IFRS. We argued that IASB and the FASB should avoid making changes on key issues such as this in a piece-meal fashion, and also that the two bodies should make a sustained effort to move forward together to develop a single, global standard on financial instruments which would also address other issues arising from the financial crisis in a principled manner. For this reason we welcome the joint announcement by IASB and the FASB in November 2009 that they have now agreed on a set of core principles on fair value accounting and that their respective due process arrangements will be synchronised so that the feedback into each will be able to be considered and responded to by both bodies.

But it is crucial, for the eventual success of the joint project, that the standard-setting process remains independent of political control. IASB and the FASB both need to have the freedom of manoeuvre to develop their joint programme on the basis of what they consider, on the basis of thorough research and meaningful consultation, to be the best technical arguments. ACCA regrets the continuing political pressure being exerted on the IASB; it is disappointing that the Commission has declined to endorse the new financial instruments standard IFRS 9 after lobbying by European banks and insurers. Such pressure puts great strain on the already difficult convergence process and could seriously threaten the achievement of G20's stated goal.

On the issue of the understandability of financial reporting in its wide sense, ACCA welcomes the initiative taken by the UK Financial Reporting Council (FRC) in launching a debate about the increasing complexity of annual reports. The annual reports of banks having become uniquely voluminous and complex, making their reports more understandable and less opaque should be one of the priorities of efforts to reduce complexity in financial reporting. The primary focus in this area must be on satisfying the information requirements of equity shareholders, and alternative ways must be found of meeting the needs of other stakeholders, rather than cluttering the financial statements themselves.

8. 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.

Aside from competition, it is this issue which has most conspicuously exercised governments over recent months. This is understandable in the light of evidence that some of the institutions that have received vast sums of taxpayers' money may be using that support to provide substantial rewards to the very people who were involved in taking their institutions to the brink in the first place.

The G20 meeting in Pittsburgh in September 2009, urged on by the governments of the UK, France and Germany, took a particularly tough line on this matter, arguing that excessive compensation practices actually encouraged excessive risk taking by the banks and that the rules on remuneration needed to be reformed as a key element of the international recovery effort. It argued that supervisors should be given the responsibility to review firms' compensation policies and structures with institutional and systemic risk in mind and, if necessary to offset additional risks, apply corrective measures, such as higher capital requirements, to those firms that failed to implement sound compensation policies and practices. Supervisors should also have the ability to intervene to modify remuneration structures in the case of firms that fail or require substantial help from the taxpayer.

In Europe, the EU has followed closely the line taken by G20 by proposing new legal measures that would require banks to adopt sound remuneration policies and practices that did not encourage or reward excessive risk-taking. Supervisors would gain new powers to sanction banks whose remuneration policies did not conform with the new requirements.

In the UK, the FSA published a pay code proposal which focused on two issues: the need for boards to ensure the total amount distributed by the firm is consistent with good risk management and sustainability; and that individual compensation practices provide the right incentives.

The French Government, which has been particularly forceful on this issue, brought in new rules in November which require banks to spread incentive-related compensation over several years and to discourage 'risky' decision-making. At least half of each bonus payment will be withheld, to be paid over three years depending on performance.

ACCA accepts the argument that policies and practices on remuneration and bonuses should be operated in a way which is mindful of the wider and longer-term interests of the company concerned, and, to an appropriate extent as well, of the interests of the wider body of its stakeholders. We do not believe that evidence exists to prove that bonuses *per se* encourage irresponsible behaviour, but accept that policies and practices which do expressly or implicitly encourage short term actions and excessive risk-taking are potentially dangerous and should be officially discouraged. The question is whether irresponsible provisions on pay should stand to be dealt with by the law and/or by rigid regulatory rules, or by a more light touch regulatory approach. In our view, legislating on the issue of pay is something that should be undertaken with caution, since the law can prove to be too blunt an instrument.

Despite the understandable public disquiet about bonuses, we consider that decisions about pay should in principle remain a matter for a company's board of directors and specialist remuneration committee. These bodies will invariably have their own legal responsibilities to make decisions which they think are best for the company in the light of all known factors, which should include the company's present and future capacity to pay. That point notwithstanding, we support the idea that supervisory authorities have a legitimate interest in the issue of remuneration matters and agree that they should have the authority to review companies' policies and practices, and should have the capacity to intervene if necessary, in the overall context of ensuring that the company's actions do not incorporate excessive levels of risk which could destabilise the company itself and/or third parties.

In line with the above, we do not consider that the Obama administration's idea of a 'compensation tsar' is a reasonable one. This person would have the power to set salary and bonus levels for top executives at US companies (including Citigroup and General Motors) that have taken huge sums in emergency funds to stay afloat, and would be able to help design a pay structure for the many other firms that have received bailout money in recent months. This appears to us an ad hoc and political initiative rather than one which is designed to be consistent with good business practice in the longer term.

9. 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. To ensure the integrity of both the risk and internal audit functions they need to be given a high status within the company structure and, ideally, the officer responsible, if not a member of the board, needs to be made accountable directly to the board rather than to executive management.

There appears to be a strong consensus that failures in risk management and internal controls were among the leading causes of the problems which resulted in the banking crisis.

The de Larosière report stated bluntly that 'in many cases, risk management and monitoring practices within institutions have dramatically failed in the crisis.' He went on to argue that the risk management function must be fully independent and the senior risk officer within an organisation must hold a very high rank within the company, with full access to the board, adding that a company's risk management policies and practices should be exposed to external supervision.

The review of the UK's *Combined Code on Corporate Governance* invited evidence on the specific issue of the role of the board with regard to risk management. The *Walker Review* addressed the issue in depth and recommended, in its provisional report published in September 2009, that boards should set up risk committees, separate from the audit committee, with responsibility for advising the board on the company's exposure to risk and on its risk strategy. Walker further recommended that the risk committee should be supported by a chief risk officer who would have, where necessary, direct access to the chairman.

ACCA supports the recommendations made by de Larosière and Walker in this area. We would reiterate that what is especially urgently needed by boards is a risk assurance function that is capable of providing independent, objective and sound advice on the company's management of risk and its systems of internal control.

10. Funding

Companies in the financial sector should be required to have capital structures and levels of liquidity which correspond to the scale and the level of risk inherent in their activities and which make reasonable provision for changes in economic circumstances. International regulatory authorities should pursue a co-ordinated approach to the definition of optimal capital levels for the major retail banks

Those national governments that had felt compelled to bail out banks in their jurisdictions will have had the most obvious cause to want to reform the funding rules so as to minimise the likelihood that banks would once again call on massive state support. We have seen, accordingly, concerted action being planned with a view, primarily, to requiring banks to build up much stronger capital buffers and also to bringing in much tighter, and more easily enforceable, definitions of what constitutes 'capital'.

The over-arching international response on capital and liquidity has been founded on the goal of applying higher prudential standards to systemically important companies, as called for by G20. The summit in Pittsburgh in September 2009 committed governments to develop, by the end of 2010, internationally agreed rules to improve both the quantity and quality of bank capital and to discourage excessive leverage. These rules would be phased in as financial conditions improved and economic recovery developed, with the aim of implementation by the end of 2012. The package would involve the harmonised national implementation of higher level and better quality capital requirements, counter-cyclical capital buffers, higher capital requirements for risky products and off-balance sheet activities, together with strengthened liquidity risk requirements and forward-looking provisioning, all intended to create a financial system better prepared to withstand adverse shocks. These measures are to be developed and implemented in conjunction with improvements to the Basel II framework, to which all major financial centres within the G20 group have agreed to sign up and implement by the end of 2011.

In Europe, the EC has brought forward new proposals to reform the Capital Requirements Directive so as to impose higher capital requirements for re-securitisations. These measures follow steps that had already been set in train to impose clearer, EU-wide criteria for defining capital, particularly as regards so-called 'hybrid' capital, and for improving standards of liquidity risk management.

In October, the FSA published its new rules on liquidity requirements for UK banks. These feature enhanced systems and control requirements and a narrower and tighter definition of 'liquid' assets. The FSA's policy response in this area reflects its conclusion that those firms which had held truly 'liquid' assets, eg government bonds, proved to be better placed to withstand the worst effects of the financial crisis.

We regard the changes regarding enhanced capital requirements to be inevitable. Likewise, liquidity. There is potentially, though, a problem with the G20 approach. The Pittsburgh communiqué committed governments to phase in the agreed measures as financial conditions improve and economic recovery continues, with full implementation by the end of 2012. This will be when the taxpayer-provided liquidity to the banks is due to be withdrawn. But the plan presumes that 2013 will see the banks' capital bases being extensively rebuilt by the market. There must be a serious question over whether that will happen, given that investors became used, over many years, to high returns on equity from banking. If this does not happen, it places a question mark against the G20's intentions on reduced leverage.

Conclusion

Given the pace of regulatory developments over the past six months, any policy paper risks being out of date as soon as it is printed. This is why ACCA continues to shape its contribution to the on-going debate in terms of principles which we believe should be central to any overhaul of the regulatory architecture.

We are encouraged that many of the points we made in our June 2009 paper have been adopted by policymakers in the proposals published since then. We particularly welcome the fact that calls for a international super-regulator in Europe have been dropped and that, instead, a systemic risk body along the lines of the ESRB will be created. It would have been perverse if the lesson learned from the build-up of monolithic 'too big to fail' financial institutions had been to re-create such a body in the regulatory sphere. Regulators need to be local and close to those being regulated. The creation of mechanisms which will allow sharing of knowledge and best practice between national regulators must be welcomed but we accept that there is a difficult balance to strike between the implementation of internationally-agreed rules to prevent arbitrage and the imposition of a 'one-size fits all' regime which may not be suited to local circumstances.

There are areas, notably on ethics, where ACCA still believes considerable progress needs to be made and we look forward to seeing specific proposals to turn the G20's exhortation of the promotion of integrity in financial institutions into reality. This would do much to enhance the effectiveness of regulation. Similarly, governments must put the promotion of competition at the heart of their approach and the re-imposition of *Glass-Steagall* principles would do much to address the 'too big to fail' problem. This, we believe, is more important than the politically potent issue of bank bonuses which, while it arouses understandable concerns, risks distracting authorities from the real issues.

We look forward to discussing the points raised in this paper with policymakers and all interested parties as the regulation debate moves into 2010.

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