International Federation of Accountants®

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FROM CRISIS TO CONFIDENCE:

GOOD REGULATION, GOVERNANCE, AND CULTURE

LONDON, OCTOBER 2016

ROUNDTABLE HIGHLIGHTS

"If you get corporate governance right, it can eliminate the need to regulate every eventuality—the corporate governance space is as important as the regulatory space. And the professions that advise businesses play an important role."

- Baroness Sharon Bowles

"The question for us is whether regulatory cooperation achieves its objectives and is organized strategically to avoid turning the national fragmentation into regional fragmentation. In that respect, our work shows that the capacity of international standards to support regulatory coherence is undoubtedly underused"

- Céline Kauffmann, Deputy Head, Regulatory Policy Division, OECD (see International Regulatory Co-operation: Better Rules for Globalisation)

"Although regulation is only one piece of the puzzle, we cannot rebuild trust unless society has faith that those regulations protect the public interest. This trust is undermined when the rules are too complex, too fragmented, or their purpose is unclear. At the same time, we need to recognise that regulation can't do it all. Companies must take responsibility for the way they operate. This is why we are calling for everyone to work together to end the culture of piling on more and more rules and find answers that achieve the primary aims of protecting the public and encouraging ethical behaviour."

- Michael Izza, ICAEW Chief Executive

"The expertise of the roundtable's participants makes their clear and candid call for stronger organizational governance all the more important. At a time when we are seeing citizens express a deepening mistrust of government and institutions through the political process, reframing the thinking around how to develop smart and effective regulation is vital."

- Fayez Choudhury, IFAC Chief Executive Officer

"There's a dilemma, good regulation for the future demands a process of trial and error but industry and the economy also need stability. Nonetheless, the Basel Committee has to take seriously Chairman Ingves's commitment to see how it works and fix what doesn't."

- David Schraa, Regulatory Counsel, Institute of International Finance

"Business is calling for regulatory frameworks that enable private sector led growth. International regulatory cooperation must stay high on the agenda. IFAC is one of our most active and valued associate experts in this field."

- Maud Garnier, Director Policy & Public Affairs, BIAC

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FOREWORD

On July 20, 2016 more than 50 senior executives, regulators, professionals, and academics gathered in Chartered Accountants Hall, London to discuss and debate how the global regulatory environment can be enhanced – with an ultimate goal of improving confidence in the financial and capital markets, business, and government.

The second[1] in a series of international discussions, the roundtable convened experienced individuals from a broad range of sectors and businesses across the economy—with an emphasis on the financial sector and professional services—individuals who have a deep understanding of the issues and their impacts.

This paper summarizes the discussion, including several imperatives for global regulation, which emphasized that public trust in the financial and capital markets, business, and government depends not only on effective, smart regulation, but also on strong governance that embeds the right cultures, ethics, and values.

[1] Roundtable summary, Hong Kong, December 2015, https://www.ifac.org/publications-resources/crisis-confidence-call-consistent-high-quality-global-regulation

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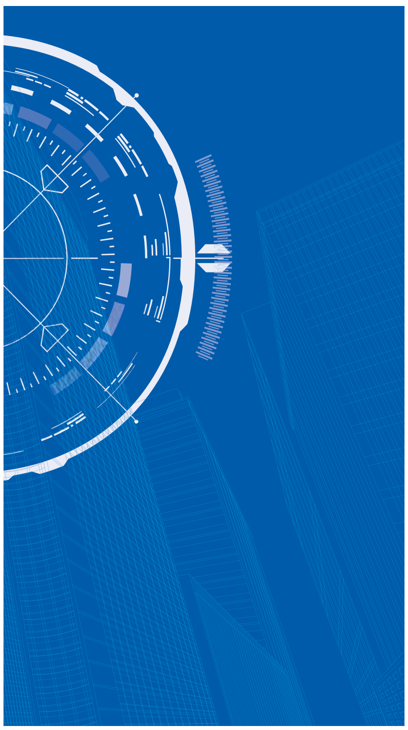
1. REGULATION, GOVERNANCE, AND CULTURE: WORKING TO REGAIN PUBLIC TRUST IN FINANCIAL AND CAPITAL MARKETS, BUSINESS, AND GOVERNMENT

> "A community of good culture has to be established in organizations, where individuals feel comfortable and empowered to challenge."



Almost a decade on from the global financial crisis, rebuilding public trust in financial and capital markets, business, and government remains a vital goal, despite the significant progress achieved from a regulatory perspective. Governments acted decisively at the international and national levels early on after the crisis, but regulation is not a panacea and it cannot solve every problem by itself; stronger corporate governance, and embedding the right cultures in organizations from the top down, are key.

Ongoing economic hardship in many parts of the world, including the long-term effects of actions taken to stabilize the financial system immediately following the crisis, has emphasized the divide between the "haves" and the "have nots." This, combined with the public's observation that the people whose behaviors caused the crisis have not been held accountable, has resulted in considerable political unrest including moves toward what seem like more extreme political narratives and choices across the developed world.

> "Values should drive our behavior, not rules."

> "Right now, the evidence shows the markets don't appear to 'value' values and doing the right thing."

> "The 'Do nothing is safest' option in reporting bad behavior has to be taken away."

"Lack of trust is intensifying an 'anti-globalization', 'post-truth' movement."

"How do you measure and take the temperature of culture in an organization without dissecting and killing it."

"The cost of being found out needs to be enough to change behaviors"

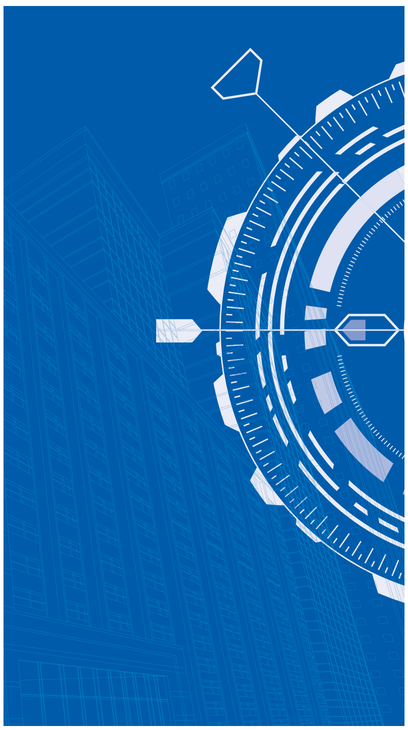
The roundtable discussion highlighted the need to strengthen governance and ethics, and to continue to refine regulation in order to restore public trust. Important questions raised included:

- What impact is regulation having on the ability of organizational governance structures to holistically address culture in organizations?
- Can regulation promote and advance better governance and conduct?
- To whom should regulators, including international regulatory organizations, be accountable?

Regaining the public trust demands not only effectiveness in regulation and governance, but visible positive examples of their benefits in financial and capital markets, business, and government.

"When it comes to 'culture' and 'conduct' – you can't talk about one without the other."

2. ADDRESSING REGULATORY FRAGMENTATION IN A WORLD OF DIFFERENT CULTURES AND EXPECTATIONS.



Regulation is required where there is a need to reconcile differences between organizations' and individuals' self-interest and the wider public or societal interest.

While the public interest might be understood at a national level, the notion of a global public interest remains very difficult. Differences in cultures and expectations concerning regulation, and different legal environments, are leading to an increasingly fragmented international regulatory environment.

> "'Global public interest' is a very hard concept, but 'national public interest' is more possible to talk about."

> "Who are regulators accountable to? Domestically, internationally?"

In the midst of the crisis, the aspiration for a more harmonized international regulatory environment was clear, as evidenced by the work of the G-20—including the establishment of the Financial Stability Board. However, in reality, most of the post-crisis regulatory actions have been primarily at a national level, and even where they reflected international consensus they often contained options and discretion.

There are clear signs in many regions of increasing nationalism—it is important that this is recognized and addressed. A lack of trust in the institutions established to protect the public interest has both led to and amplified these sentiments.

> "The future looks much more fragmented today than at the depths of the crisis."

Roundtable participants noted that the problems caused by regulatory fragmentation are well-recognized, including inefficient use of capital and resources, unlevel playing fields, regulatory arbitrage, impacts on trade, and costs to the global economy. However, it is less clear what the ultimate goal of regulatory harmonization looks like, resulting in a tension between:

- The reality of a world that is made up of many cultures and different expectations concerning regulation, which necessarily means many different and possibly conflicting regulatory approaches; and
- An increasingly globalized economy and seeking to better understand and address the substantial costs, risks, and negative impacts of regulatory fragmentation.

> "The assumption that harmonization of regulation is the goal should be challenged."

While an ideal world of perfectly harmonized regulation is unachievable, greater attention is needed to better understand and restrict the negative impacts of increasing fragmentation.

> "Accountability for regulation remains at a national level, despite whatever consensus may be achieved internationally."

3. THE GROWING COMPLEXITY OF REGULATION AND THE NEED FOR SIMPLICITY IN A COMPLEX WORLD.

Regulation throughout the global economy, particularly the financial sector, is becoming increasingly complex, and roundtable participants anticipated this would continue. Achieving the right balance in the regulatory environment—between unnecessary complexity and self-defeating simplicity—is essential.

> "Negotiation on international regulatory approaches creates compromise and complexity that we have to work better to balance."

More complex regulation has been a response to larger and more complex global entities and challenges. Unnecessary, problematic complexity is sometimes created where compliance-based regulatory solutions are sought for problems that, at their core, demand stronger governance and more holistic behavioral change.

Complex regulation also impacts large and small entities differently. The capacity for small- and medium-sized entities (SMEs) to survive, grow, and compete can be adversely impacted by complex regulation. Given the importance of SMEs for jobs, growth, and prosperity throughout the global economy, addressing proportionality in regulation and rule-making is essential.

> "There is a risk of 'risk aversion' and over reaction; appropriate risk-taking needs to be preserved."

Calls for large, multinational entities—especially banks—to be "broken up" have been increasing in public and regulatory discourse. Conceptually, this has an attractive simplicity. However, it is likely that the pace of change and the advantages gained through greater connectivity and integration in the global economy will continue—meaning that such simplistic measures may not be practical. In fact, they may hinder growth and stability and unintentionally add to the complexity of the regulatory environment.

"Can economies of scale outweigh diseconomies of scale?"

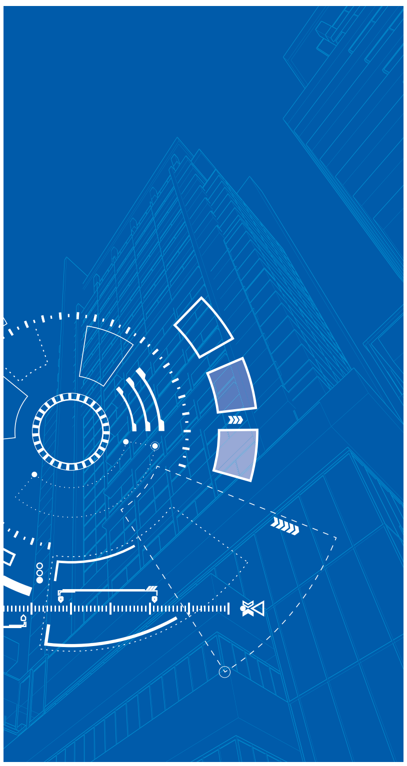
"There needs to be regulatory 'pre-nup'."

Roundtable participants recognized that there also appears to be an increasing volume of global regulation—that is, continually adding and never subtracting. They inquired whether a dynamic could be created that rolls back regulation over time. Post-implementation reviews and sunset clauses are seen as valuable tools to achieve this objective. Participants also probed whether it would be possible for more ongoing, real-time review of regulation to be undertaken, rather than periodic reviews—including drawing on emerging technology to measure outcomes and establish a greater level of feedback.

A trend in the global regulatory environment toward process-oriented, compliance-based regulatory approaches was also discussed. Regulatory approaches that focus more on the desirable outcomes, and seek to influence organizational culture and promote effective governance, are necessary. Ultimately, they identified a pressing need for greater clarity around the objectives of regulation—whether it is to mitigate failure, address behaviors or conflicts of interest, or a combination of these and other factors. The right tool for the job can only be determined when the problem is clearly understood.

"We have to compare our own sectors' approach to preventative regulation, with that of say airline pilots, or doctors."

4. FUTURE-ORIENTED AND COLLABORATIVE REGULATION FOCUSING ON TOMORROW'S PROBLEMS RATHER THAN YESTERDAY'S.



Roundtable participants perceived that many regulatory reforms in response to the crisis focused on addressing past risks and issues, rather than taking a more forward-looking approach. The contrast between a holistic view that seeks to create a stronger system for today and tomorrow, and a view that aims to address past issues and risks, is stark.

Effective regulation demands buy-in from and collaboration among all stakeholders—regulators and policy makers, those who are regulated, and the beneficiaries of regulation. Dialogue and collaboration has improved in some sectors since the crisis, allowing issues and risks to be highlighted earlier and enabling more effective and innovative approaches (refer to box "Improving dialogue between the auditing profession and bank regulators"). A future-oriented approach, aimed at identifying and discussing emerging trends and risks—rather than focusing too much on the past—appears to have underpinned improved dialogue between stakeholders.

"There is no effective alternative to dialogue and collaboration among all regulatory stakeholders in identifying and addressing emerging risks."

"Those in t-shirts and jeans can affirm 'reg-tech' holds many transformative possibilities, but the legal and regulatory challenges are significant, and those of us in suits need to ensure it's not held back."

Effective reporting and surveillance is a crucial part of a forward-looking, risk-based regulatory system. "Reg-tech" is opening up new opportunities for real-time monitoring, and new analytical methods—including machine learning and artificial intelligence—are providing the tools needed for regulators to assimilate vast amounts of data. As these technologies continue to evolve, regulatory practices may become unrecognizable from their present form.

IMPROVING DIALOGUE BETWEEN THE AUDITING PROFESSION AND BANK REGULATORS

Since the crisis, a more frequent and discursive dialogue has been established in the UK between the auditors of major banks, the ICAEW, and the Prudential Regulation Authority within the Bank of England. This dialogue improves the prospect that issues impacting the sector will be identified earlier, and means that the expectations of these stakeholders can be more frequently calibrated and aligned.

PRINCIPLES OF GOOD REGULATION

The London roundtable discussion covered a number of topics related to the principles developed at an earlier roundtable held in Hong Kong in December 2015. However, a broader number of topics were highlighted at the London roundtable, including issues of trust, conduct, and governance, arguably extending and creating a better encapsulation of the principles. As agreed at the earlier roundtable, these principles should underpin the development and implementation of regulation—not only the rules themselves, but also actions, structures, and processes that create the context in which regulation is applied and enforced.

Clear objectives in the public interest: Regulations should be based on a clearly articulated goal that all participants agree is in the public interest.

- **Proportionate and balanced approach:** Although regulations are often designed to handle the outliers, good regulations are applicable to organizations of all types, and are structured to scale for different sizes of organizations.
- **Evidence-based assessment:** New regulations should be subject to an impact evaluation that evaluates effectiveness as well as both financial and time costs.
- **Appropriate resourcing for regulators:** Too often, regulators do not have the resources needed to address the complexity and scale of the corporations and markets they are expected to regulate.
- **Collaborative action:** A lack of robust incentives for collaboration creates country-based regulatory ecosystems. New incentives such as education, advocacy support, and increased global forums could trigger deeper cooperation.
- **Consistent and coherent:** While many individual jurisdictions still have room for improvement to create consistent regulatory systems, the biggest gap exists on a global scale.
- **Active oversight:** The need for more active and independent oversight of regulators was raised as a significant challenge, including determining who should undertake this role.
- **Transparent and open consultation:** For an effective regulatory system, buy-in is needed from all regulatory stakeholders--this means all need to be heard and involved appropriately in the development of regulation.
- **Systematic review:** Participants broadly supported systematic reviews of how new regulations are performing, including sunset clauses and mechanisms that would enable ongoing, real-time review.
- **Deliberate enforcement:** Fair and visible enforcement was seen as an important factor in ensuring confidence in regulation, and the environment for finance and business.

[2] https://www.ifac.org/publications-resources/crisis-confidence-call-consistent-high-quality-global-regulation

PARTICIPANTS

Senior representatives from the following organizations participated in the discussions:

- Institute of Chartered Accountants in England and Wales
- International Federation of Accountants
- ACCA Global
- Attolini Spaggiari & Associati
- Bank of England
- Barclays
- BDO
- Business and Industry Advisory Committee to the Organisation of Economic Co-Operation and Development
- Centre for the Study of Financial Innovation
- Chartered Institute of Management Accountants
- Chartered Institute of Public Finance and Accountancy
- Citi
- Deloitte
- Department of Innovation and Skills, UK Government
- Délégation Internationale pour l'Audit et la Comptabilité
- European Banking Authority

- European Federation of Accountants and Auditors for Small and Medium-sized Enterprises
- European Securities and Markets Authority
- EY
- Financial Reporting Council
- Grant Thornton
- Independent Audit
- Institute of International Finance
- Intellectual Property Regulation Board
- International Organization of Securities Commissions
- James Cowper Kreston
- KPMG
- Kreston Reeves
- Legal Ombudsman
- Legal Services Board
- Liberal Democrats
- Lloyds of London
- Organisation for Economic Co-operation and Development
- Paul Hastings
- Prudential Regulation Authority
- Public Interest Oversight Board
- PwC
- Royal London
- Smithfield
- Standard Chartered
- The Association of Corporate Treasurers
- TheCityUK
- The London Institute of Banking & Finance
- University of Glasgow

The event was moderated by Professor Peter Hahn of The London Institute of Banking & Finance.

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