

WHAT MAKES GOOD REGULATION?

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Introduction

Good afternoon. There are two compelling reasons why I accepted the offer to participate on today's panel. First, I hope that I can present some perspectives from my experience as a regulator over many years, the insights I have gained from my work at the PIOB and my reflections as a financial economist. Secondly, as a regulator, I firmly believe that good regulation must start with a clear understanding of the objective - and this necessitates a trilateral dialogue between regulators, the regulated community, and the beneficiaries of regulation. To this end I am delighted to have the opportunity to engage with so many representatives of the accounting profession in the audience today. And in the spirit of engagement I will pose some questions that I hope will act as a prompt for further interaction with you over the course of this panel session.

My immediate response to the question of "What makes good regulation?" is actually very simple - "Good Regulation serves the public interest through supporting ongoing confidence in processes, such as the market process, in which the public participates and in activities, such as auditing, on which the public relies". I will start today by outlining why I see regulation as necessary to support confidence in markets, and trust in the reliability of financial reporting and financial services generally.

To this end, I also plan to explore the issue of whether regulation should take the form of high-level principles or detailed rules, as well as making some observations regarding self regulation and external regulation.

As a very basic premise let me say that regulation must act, and be seen to act, in the public interest. But for good regulation to deliver public interest results it must take into account different and often competing aims and objectives. This necessitates that I address some criteria that may be useful in assessing whether particular regulation is "good". I will conclude by touching on IFAC Reforms which included the introduction of independent oversight of IFAC's standard setting and compliance activities by the PIOB.

Trust & Confidence

Markets function more effectively when supported by an underlying sense of trust. I don't need to justify this statement with a complex explanation of economic decision-making theories. As employees we trust that we will receive payment for our services. As employers we trust that those we employ will provide the services for which we pay. As investors we trust that those we engage to act according to our interest will do so. The maintenance of trust and confidence depends not only on promises but more importantly on consistency of actions.

Regulation is an outcome of the way society perceives and responds to risk and to excessive risk taking. Regulation may be defined as the combination of organizations, rules, and sanctions that result in behaviors consistent with orderly markets, accountability, transparency and stability. A major objective of regulation is to safeguard the public interest by maintaining protection of economies from systemic risks, and protection of market participants from unwanted, opaque or unacknowledged private risks. This applies especially to investors who feed the markets with their savings. It is in that context that good regulation should be viewed as a driving force for reliable and high quality financial services.

Regulatory reform, more often than not, is a response to widespread perceptions of inadequacy of existing systems, and to crises when they happen. Whether we like it or not, very clear problems do require urgent action to avoid a complete loss of trust and confidence that would undermine the entire market system. In the same way that air will move swiftly to fill a vacuum, regulation too increases swiftly to fill a perceived vacuum in governance, transparency, accountability or confidence.

So my first question to you is the following: As a profession can you do more to ensure an improvement in quality and an ongoing positive perception of the quality of financial reporting?

Principles versus rules

There has been significant debate about the relative merits of principles and rules that would tend to suggest that the two approaches are mutually exclusive. This is certainly not the case. Principles often include rules to assist in their implementation. Similarly, rulebooks often contain options where different actions and potentially quite different results still meet the objectives of the rules.

Personally, I prefer the use of principles to guide the actions of individuals and groups rather than establishing detailed sets of rules.

We can be confident that some people will ignore legal requirements regardless of their form of expression. Others will look to circumvent the law by acting within its letter but ignoring its spirit, exploiting small print and loopholes. However, the vast majority that aim to do the right thing will achieve that outcome equally well under a system guided by principles or by rules.

My preference for principles stems from a desire for relationships based on trust rather than suspicion. If we trust someone simply because legal sanctions apply for breaking rules, we do not, in fact, trust them at all.

I also see principles as having an inherent aspirational quality that rules simply cannot support. For example, it would be impossible to craft a rule that instills true commitment to constant improvement in the quality and reliability of services, or to the public interest.

Another highly practical attraction is that establishing principles rather than rules allows regulation to respond effectively to evolving conditions without the need for constant amendment. Just as consistency of actions promotes confidence, too frequent amendments to rules can actually undermine it.

It is an observable fact that within the accounting profession there are some who wholeheartedly support the use of principles to establish the objective of regulation while also allowing for interpretation. Others demand the absolute legal certainty that flows only from applying detailed rules. So my second question for you to think about is: How can those trying to develop globally acceptable and applicable standards bridge this divide?

Self versus External Regulation

You can find a parallel to the principles versus rules debate in discussions focused on self versus external regulation. These discussions flow from fundamental changes to the structure, operation, and ownership of capital markets but are equally applicable to any profession, industry or service.

Some commentators suggest that the approaches are at opposite ends of a spectrum of desirable institutional arrangements. This thinking is fundamentally flawed. That is to say, it does not necessarily follow that the more you have of one type of regulation the less you need of the other. The use of each type in a given situation will be determined by market conditions, traditional roles of various institutions, instances of failure and perceived conflicts. Fundamental changes in perceptions, whether a result of structural developments, innovation or market failure, often necessitate a review of regulation to ensure it continues to achieve its objectives.

The question should not be how much or how little of each type of regulation is necessary. Rather, each type of regulation should complement the other. The aim is to establish a mix of policies and institutions that facilitate orderly functioning of the market and promote trust.

This leads to further questions. How do you see the current mix of self and external regulation in your jurisdiction? Can self regulation achieve more than it does currently?

Criteria for Good Regulation

I said at the outset that I would spend some time on criteria that might be used to assess whether regulation is indeed “good”. The following are not of my own making, but continue to evolve as the role of regulation is considered in fora such as this.

The first is *Necessity*.

What are we responding to?

What are we trying to achieve?

Are the structures and approaches that govern the area still appropriate?

Are the regulatory changes contemplated appropriate for the long run, or are they only a short term response?

National governments, regulators and others can often be overwhelmed by the need to respond quickly and sympathetically to try to make things better. Problems become highly visible, often because the media is quick to sensationalize, and so these problems quickly permeate and become the focus of delicate political debates. At the same time, we must also remember that those who suffer are real people, not statistics.

Under these conditions, increases in external regulation must still be carefully weighed. First, they must not create burdensome bureaucracies as then the cure may become worse than the disease. Second, they must not induce a false sense of security and inappropriate attitudes towards risk, since we all know that frauds and crises can never be completely banished in a market system. In the end, well-functioning markets must maintain “Caveat emptor” as a key component.

The development of regulation should also include an understanding of the history of regulation and past experience of regulatory impact on markets. It should benefit from an understanding of how regulation developed and changed in older times and circumstances.

Another criterion is *Transparency*.

Have stakeholders been consulted about the regulation?

Transparency in the development of regulation can be closely aligned with inclusiveness and accountability. A framework is vital to clearly establish how exposure, consultation and criticism should flow during the development phase of regulation. In other words, clarity in articulating the objectives of regulation, and the alternative methods of achieving these, need to be debated and all interested parties should be able to provide input.

At the PIOB we refer to this as due process, and we believe that it is a critical component particularly where regulation, in this case the setting of professional standards, is intended to apply across jurisdictions. Local environments vary widely in terms of development, law, history and corporate structures and this variance must be incorporated into the final design of any regulation.

Transparency behaves much like a suggestion box where useful improvements or the identification of inadequacies can come from any number of sources with different perspectives. Of course, I am not suggesting that good regulation results from a process of compromise, where all suggestions are somehow incorporated into a patchwork solution no matter what the result. Indeed I believe quite the opposite is true. Transparency is concerned with ensuring that all interested parties are given the opportunity to comment and will be satisfied that all comments and suggestions received proper consideration, so that only the best quality regulation emerges. Therefore, the final result should make it clear how items of substance raised during the development phase were dealt with.

Another factor in developing good regulation is *Proportionality*.

Do the advantages to be derived from regulation outweigh the disadvantages of that regulation?

Those against the introduction of additional regulations often talk about using a hammer to crack an egg. While this creates a vivid mental picture it often overstates the impact.

An analytical tool that is frequently used to gauge proportionality is Regulatory Impact Analysis or RIA. This is an evidence-based approach that allows for the systemic consideration of the benefits and costs of a regulatory proposal to the economy and society. RIA attempts to assign financial values to facilitate comparisons. I am not against the use of this tool as an input into the development of good regulation, but I am strongly opposed to exclusive reliance on such models. Models use assumptions and estimations of parameters which may change in application. Furthermore, costs are frequently much easier to assess than benefits which may be diffuse. After all, what value can you assign to maintaining trust?

Effectiveness must also feature as a criterion in the design of good regulation.

Is the regulation properly targeted?

Will the regulation give rise to anomalies and inconsistencies?

Can it and will it be properly complied with and enforced?

First, it is essential for regulation to begin and end with the beneficiaries of that regulation. Second, at the point that the ink dries on the facilitating instrument, implementation - the real challenge of regulation - begins.

Measuring the effectiveness of regulation is made even more complex because maintaining compliance in a variety of environments is hard work. I was struck by the conversations during my last visit to Mexico City about the enormous challenges faced here and elsewhere by the accounting profession and the difficulties in achieving proper implementation of international standards. At the PIOB, we recognize that consideration of the public interest is not limited to the needs of major capital markets, but requires an awareness and sensitivity to the issues and needs of a broad variety of constituents.

Finally a good regulatory system must exhibit *Flexibility*.

In other words, does the regulation consider potential future developments or does it stifle innovation?

Any system of regulation imposes requirements on somebody in order to achieve a level of protection and reliability for somebody else. Often the requirements take the form of restrictions imposed upon an industry or profession.

If we are truly looking for continuous improvement in the provision of services, then regulation must allow for innovation. To rely and trust that professionals will make use of their experience and apply their judgment, we must also accept that while acting in good faith they may make mistakes or come up with unpredicted alternatives. If regulations apply sanctions where honest attempts have been made to fulfill regulatory objectives, then there is a clear risk that innovation and judgement will be stifled.

So let me repeat the five criteria that I believe promote the development of good regulation: necessity, transparency, proportionality, effectiveness and flexibility.

IFAC reform, the PIOB and the public interest

Let me move now to the example that I am quite familiar with and which I believe is delivering, and can continue to deliver, good regulation that is in the public interest.

The IFAC reform program was an acknowledgement that the existing self-regulatory system of standard setting needed to change and that change meant the installation of independent oversight in the public interest. Regional financial instability, high profile scandals and corporate failures had eroded public confidence in both the process of auditing financial statements and the governance of the accounting and audit profession generally. The system of self regulation was perceived to have failed those whom it was supposed to protect and therefore needed reform. Quite apart from the incidents that precipitated regulatory and IFAC reform, there was already widespread recognition that

fragmented accounting and auditing standards, inconsistent application and non-comparable financial statements posed dangers in increasingly integrated global financial markets.

This reform included specific steps to strengthen the transparency and independence of IFAC standard-setting committees. It also included the formation of the Compliance Advisory Panel. The IFAC compliance program and its Compliance Advisory Panel which the PIOB oversees, has collected self assessments from IFAC member bodies and is in the process of determining appropriate action plans to improve levels of compliance with the IFAC Statements of Membership Obligations. Progress in this area deserves close PIOB attention and is an important task for us. Our job will be to decide whether the CAP's approach to member body evaluations and action plans properly serves the public interest.

Finally, to address the major issue of accountability, the reforms sought a unique approach through the creation of an independent body – the PIOB – that would oversee IFAC's standard setting and compliance activities to ensure they were being properly responsive to the public interest.

To help communicate and clarify its mandate, the PIOB developed an initial view of the main elements of “the public interest”:

- To produce international standards that would cover all aspects of the audit process and the education and ethical conduct of those engaged in preparing and auditing financial statements;
- To produce standards that would be not only of high quality but also of high clarity and usability;
- That those setting international standards must enjoy high credibility among world stakeholders by being committed to the public interest, coming from diverse backgrounds, acting independently and being agile and responsive to emerging needs of standard users;

- To promote and facilitate compliance with IFAC standards by the member bodies of IFAC around the world; and
- That the process by which international standards were developed should become and remain open, transparent and responsive to the views and needs of all who would use or are subject to the standards.

It is no accident that the PIOB view of the appropriate process for setting international standards in fact incorporates the criteria I have previously outlined. Necessity, transparency, proportionality, effectiveness and flexibility are strong underlying determinants in our emerging view of the international public interest in standard setting

It is a truism that confidence once lost is hard to regain. The PIOB continues to work to re-establish confidence in the standard setting processes and in efforts to improve member body compliance with the obligations of IFAC membership.

There is a role for all of us in this pursuit. Promoting the development of good regulatory structures, promoting the practice of good regulation, and promoting a culture of compliance requires multiple and coordinated efforts. I encourage all of you to continually ask “How can I participate to make the process better and to make the outcomes of regulation match its objectives?”