The role of the external auditor in bank regulation and supervision: A comparative analysis between the UK, Germany, Italy and the US

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THE EXTERNAL AUDITOR'S ROLE IN BANK REGULATION AND SUPERVISION: A COMPARATIVE ANALYSIS BETWEEN THE UK, GERMANY, ITALY AND THE US

7.1 Introduction

This comparative analysis discusses the differences between the structure and systems of bank regulation operating in the UK, Germany, Italy and the US. The importance of harmonisation in achieving stated supervisory objectives is also emphasised. The main objective of this chapter is to illustrate how the external auditor's role could be harnessed more efficiently in the UK banking regulatory and supervisory process. This is of particular importance given the reduced supervisory role which the Bank of England has assumed since banking regulatory and supervisory powers and functions were transferred to the Financial Services Authority. External audits and in particular external auditors, have a greater role to play in bank regulation and supervision than was the case over 20 years ago. This is so mainly as a result of globalisation. The need for a single regulator which regulates not just the banking sector, but also the insurance and securities sectors, has arisen principally because of the rise of conglomerate firms. Single regulators are able to manage more effectively cross sector services' risks. Correspondingly, the functional overlaps between banking, insurance and securities business and their universal scope make it more difficult for a regulator to observe and comprehend such businesses.[1] The difficulty of measuring and assessing risk within such institutions along with the speed with which assets can be adjusted in derivatives markets has led to more emphasis being placed on internal managerial control. [2] Consideration is also being given to the structures that can be put in place to re inforce the incentives of all parties involved – not just to management but all parties including auditors and regulators.[3]

Because banking has evolved to a stage where conglomerates now have a significant presence and provide a range of services (and not just banking services), and because of the growing presence of international firms, the role of the external auditor has become so important.

Since 2001, large listed companies in Germany have increasingly used US or International

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1 CAE Goodhart, (ed) *'The Emerging Framework of Financial Regulation* (Central Banking Publications Ltd London 1998) 95-96
2 ibid
3 ibid

Financial Reporting Standards (IFRSs) accounting for their consolidated statements.[4] The presence of international accounting firms calls for greater harmonisation efforts in relation to international accounting standards as this would facilitate better and more effective enforcement procedures.[5] However, there are various obstacles to harmonisation (and in particular, to EU harmonisation) because of the nature of the audit profession in various EU jurisdictions nature of the audit profession contributes to the type of accounting that is practised and that could be practised.[6] A 1975 Decree in Italy which required listed companies to have extended audits similar to those operating in the UK and the US could only be brought into effect during the 1980s because of the substantial increase in the number of international accounting firms.[7]

Effective supervision on a global consolidated basis and the internationalisation of banking generally, calls for close co-operation between national supervisors. It is therefore of great significance that although several obstacles have been encountered, immense progress has been made over the past decade in developing a multilateral framework based on the Basel Committee Banking Regulatory and Supervisory practices.[8]

This chapter amongst other objectives, aims to show why it is important for the FSA to use specialists such as external auditors to make up for (but not substitute for) the Bank of England's reduced presence in the supervision process. The benefits of the central bank's involvement in banking supervision in jurisdictions such as Germany, Italy and the US will be considered as part of the first main investigational objective, which is, the rationale for a single regulator.

The perceived advantage of the German system over the UK system of financial supervision is due to the fact that Germany's central bank, the *Bundesbank* still retains supervisory functions (naturally as well as monetary policy setting functions) whilst benefiting from attributes of a single regulator (one of such attributes being the ability of a single regulator to manage cross sector services' risks

[4] C Nobes and R Parker, *Comparative International Accounting* (Prentice Hall London , Ninth Edition) 569

[5] Major reasons for foreign banks establishing their physical presence in the early 60s in the UK resulted from the prominence of London as an international financial centre, the absence of entry restraints and a flexible regulatory treatment. The number of foreign banks steadily grew between 1962 and 1982 from 51 to 232. The economic potential and performance of the German economy, the strong presence of foreign owned non-financial enterprises and the importance of German foreign trade have played a part in motivating the establishment of foreign bank offices in Germany. In Italy, the servicing of multinational corporations and trade financing have been the principal initiatives for the growth of foreign banking presence there. See RM Pecchioli, 'Trends in Banking Structure and Regulation in OECD Countries, The Internationalisation of Banking: The Policy Issues [1983] 68

[6] C Nobes and R Parker, *Comparative International Accounting* p 27

[7] Ibid p 27

[8] 'Trends in Banking Structure and Regulation in OECD Countries' [1987] 14-15

more effectively). In contrast, the UK system of financial services supervision comprises a system whereby banking supervisory functions of the central bank have been transferred to its single regulator, the Financial Services Authority. However, certain disadvantages also feature within the German system of banking regulation and supervision as will be seen later on in this chapter.

Through an analysis and comparison of primary sources such as the Financial Services and Markets Act (FSMA) 2000, das Gesetz ueber das Kreditwesen, Gesetz ueber die Bundesanstalt fuer Finanzdienstleistungsaufsicht, the Italian Legislation, Law 262 of December 2005 and relevant US federal and state statutes, a basis will be provided as to how important the central bank's role is in the bank supervisory process. The historical background of banking institutions of the jurisdictions being investigated, objectives of the central banks and bank regulators of these jurisdictions will also be considered. In addition to the primary sources already mentioned, other primary and secondary sources such as annual reports from the central banks will also be considered.

Other aspects of the jurisdictional analysis relating to Germany, Italy and the US include the second main investigational aim of this chapter, their approaches to risk-based supervision. Risk based regulation is a growing phenomenon across several jurisdictions and external auditors can play an important role not only in risk based regulation, but also in the Basel II process. They can assist in the validation process of the advanced techniques used for measurements under the Basel II Accord.[9]

In addition to this role, external auditors can also help the regulator in the process of obtaining information which the regulator needs to assess whether a regulated institution is complying with required standards. If the external auditor's roles in bank regulation and supervision are to be effective, then safeguards and measures need to be in operation in order to protect his independence.

The third major investigational aim explores safeguards in place to protect the external auditor's independence in these jurisdictions. Ethical guidance issued by international bodies such as La Federation des Experts Comptables Europeens (FEE), the International Federation of Accountants (IFAC) and activities of the Securities and Exchange Commission (SEC) and Independent Standards Board in the US have facilitated discussions on the issue of the independence of the

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[9] E Huepkes, 'The External Auditor and the Bank Supervisor: Sherlock Holmes and Doctor Watson?' (2005) No1/2 Journal of Banking Regulation 7

external auditor.[10]

Safeguards to auditor independence in some countries are considered to be barriers to promoting a single European audit market. The Italian position on the issue of auditor independence differs considerably from that adopted by the UK profession and such differences have understandably led to difficulties in harmonisation[11]. The European Commission issued a Consultative Paper dealing with fundamental principles on statutory auditor independence to be adopted by Member states into their own regulation.[12] This EC Paper, has to a large extent, been influenced by the UK position on the issue of auditor independence.[13]

It had been intended that the EC's Eighth Council Directive would harmonise the regulation of auditors in the European Union.[14] The Directive considers the harmonisation of the conditions for the approval of auditors.[15] It also deals with auditor competence, integrity, independence and liability.[16] As regards the issue of auditor independence, the Directive assigns authority to Member States for making sure that statutory auditors are sufficiently independent of clients whom they are auditing.[17] The Green Paper, which was published in 1996, deals with the role, position and liability of statutory auditors in the EU.[18] The Federation des Experts Comptables Europeens (FEE) which represents major European professional accounting bodies also contributed a paper to this debate.

Categories of threat to auditor independence include:

Self Interest

This arises when auditors have financial or other interests which might result to them being

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[10] J Stevenson, 'Auditor Independence: A Comparative Descriptive Study of the UK, France and Italy' [2002] International Journal of Auditing 155

[11] Also see C Nobes and R Parker, *Comparative International Accounting* at p 95,100

[12] J Stevenson, 'Auditor Independence: A Comparative Descriptive Study of the UK, France and Italy' [2002] International Journal of Auditing 155

[13] ibid

[14] Ibid p 156

[15] L Evans and C Nobes, 'Harmonisation of the Structure of Audit Firms : Incorporation in the UK and Germany' (1998) 7 The European Accounting Review 125

[16] J Stevenson, 'Auditor Independence: A Comparative Descriptive Study of the UK, France and Italy' [2002] International Journal of Auditing 156

[17] ibid

[18] ibid

reluctant to take actions that would be adverse to the interests of the audit firm.[19]

Self Review

This arises when the results of a non audit service performed by the auditors or by others within the audit firm are included in the figures disclosed in the financial statements.[20] As a result of providing non audit service, the audit firm is associated with aspects of the preparation of the financial statements and may be unable to give an objective view of relevant aspects of those financial statements.[21]

Other threats to objectivity and independence include:[22]

Management threat, advocacy threat, familiarity threat and intimidation threat.

Safeguards which may reduce these threats include a combination of personal qualities (integrity and reputation) and protective measures ensuing from both the practice environment and the profession itself.[23] Protective measures could include staff training, encouragement to discuss concerns between staff, second partner review, audit partner rotation in assignments, meticulous screening of all new engagements or existing ones before re-accepting.[24] Small firms in the UK are advised to consult the Institute of Chartered Accountants in Scotland (ICAS) if some of the mentioned safeguards are inappropriate.[25] In addition, firms should consider the involvement of third parties where there is perception of a significant threat to objectivity.[26] The UK audit profession has established certain independence safeguards which include the support for members through an Ethics Secretariat and Committee, the monitoring of audit work and policing of complaints and the ethical code.[27] In addition, the Working Party Review (ICAEW 2000) has made

[19] Ethical Statement 1 Integrity, objectivity and independence paragraph 28 <http://www.asb.co.uk/apb/publications/index.cfm> (last visited 12 January 2007)
[20] ibid
[21] ibid
[22] ibid
[23] J Stevenson, 'Auditor Independence: A Comparative Descriptive Study of the UK, France and Italy' [2002] International Journal of Auditing 165
[24] ibid
[25] ibid
[26] ibid
[27] Ibid p 166

numerous recommendations aimed at strengthening the ethical guidance.[28]

As the fourth main investigational aim, the expectations gap will also be discussed but would only be considered briefly. Comparisons of the aspects being investigated will be undertaken between the UK, Germany, Italy and the US. An assessment will then follow with a conclusion which embraces proposals for reforms on the topics being considered.

Limitations of this Research

Generally, more in depth analysis and comparisons will be carried out between the UK and Germany since Germany is the only country out of all three (itself, Italy and the US), which has adopted a single financial services regulator. However, some other comparative aspects will also be discussed in greater detail between the UK and the remaining jurisdictions being investigated. Because of the importance attached to investor protection in the UK and the US, the issue of audit independence will be explored in greater depth, on a comparative level between the US and the UK. The roles of external auditors in investor protection being greater in these jurisdictions than in Germany or Italy. For an in-depth analysis of the role of the external auditor in general, please refer to chapter five.

7.2 Some Causes of International Differences in Auditing

Cultural Differences

An approach which may well explain the international differences in the behaviour of auditors is explained through Gray's contrasting pairs of accounting values namely:[29]

Professionalism versus statutory control

Uniformity versus flexibility

Conversatism versus optimism

Secrecy versus transparency

Whilst the first two relate to authority and enforcement, the second two relate to measurement and

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[28] Ibid
[29] Ibid p 18

disclosure.[30] In addition to cultural differences, there also exist colonial differences.

Legal Systems

The influence of common law (the UK and the US) and codified Roman law (Italy and Germany) on the nature of a jurisdiction's accounting rules is evidenced by the fact that common law systems influence commercial law – which traditionally does not prescribe rules to cover the behaviour of companies or how they should prepare their financial statements.[31] Accounting within such common law systems, are to a large extent, not dependent upon law as was evidenced by the UK till the UK Companies Act 1981 came along.[32] Accountants establish rules which may later become recommendations or standards and the difference between this and codified systems exists in that company law or commercial codes for codified systems need to establish rules for accounting and financial reporting.[33] In Germany, for example, company accounting constitutes to a large extent, a branch of company law.[34]

However, Cairns[35] questions the appropriateness of trying to classify and identify causes of international differences since these cannot be depended upon in order to explain differences in practice. The appropriateness of classifying certain accounting practices as 'Anglo-American' or 'Continental European' is also addressed and he highlights the fact that some French and German companies are moving towards US or international practices where the issue of financial reporting was concerned.[36]

As a result of these arguments, six observations are made by Cairns namely that:[37] 'The distinction between Anglo-American accounting and Continental European accounting is becoming less and less relevant and more and more confused'; secondly, 'Those who continue to favour these classifications are ignoring what is happening in the world and how companies actually account for transactions and events' ; thirdly, 'It is increasingly apparent that the different economic, social and legal considerations which have influenced national accounting do not necessarily result in different accounting'; fourthly, 'There are now probably far more similarities between American and German

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30 Ibid p 19
31 Ibid p 20
32 ibid
33 ibid
34 Ibid p 20
35 See D Cairns, 'The Future Shape of Harmonisation: A Reply' (1997) 6 (2) European Accounting Review 316-317
36 Ibid at pp 307-308
37 Ibid pp 316-317

accounting than there are between American and British accounting'; fifth, 'The futility of attempting to classify accounting was well demonstrated' ; and finally, 'In their attempts to maintain the distinction between Anglo-American and Continental European accounting, Flower and Nobes have started to clutch at straws. The[y] both make offensive attacks on the people involved in the work of the IASC.'

Nobes responds to these observations and particularly the fourth observation, by referring to the 1996 annual report of Daimler which stated that German and US accounting principles were based on different perspectives.[38] The principle of caution and creditor protection is identified by the German Handelsgesetzbuch (HGB) as being of greater emphasis and this is distinguished from the main objective of US accounting – which is the availability of relevant information for shareholder decision making.[39] It is therefore concluded that comparability of financial statements are of greater importance under US accounting than under the HGB.[40] Whilst Cairns may be right to conclude that there are more similarities between American and German accounting, it may be more difficult establishing his claim that those similarities are greater than those which exist between American and British accounting. As discussed at the beginning of this chapter, large listed companies in Germany are increasingly using International Financial Reporting Standards (IFRSs) accounting for their consolidated statements. However, to say that similarities between German and US firms are greater than those which exist between UK and US firms, would be to discount and discredit the fundamental importance placed in the objectives of accounting – as determined by the users of financial information in these jurisdictions. Whilst German objectives may focus on creditor protection as per the German Handelsgesetzbuch, UK and US accounting, being capital market systems place greater value on audits (as will be shown later on during the comparative section of this chapter) and this is largely as a result of the composition of the users of financial information in these jurisdictions. As a result of the existing similarities attributed by users of financial information in the UK and the US, similarities also prevail between the UK and the US in terms of the providers of finance.

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[38] See C Nobes, 'The Future Shape of Harmonisation: Some Responses' (1998) 7(2) European Accounting Review 326

[39] ibid

[40] ibid

Another blurring area of the Anglo-American and the Continental European distinction is due to the fact that it is increasingly the case that shares in the UK and the US are held by institutional rather than individual shareholders – however, this still contrasts with state, bank or family holdings.[41] Differences between UK and US accounting (as will be discussed later on during the chapter), amongst which are principles based versus rules based accounting may provide further support for Cairns argument that similarities between German and US firms are greater than those similarities between UK and US firms.

7.3 First Investigative Aim: The Rationale for a Single Regulator

Since the UK and Germany are the only jurisdictions (amongst those being investigated), who have actually adopted a single financial services regulator, the main focus of jurisdictional comparison will be between these two countries. The most important differences to note between Germany and the UK are: The degree of involvement of Germany's central bank in the supervisory process and the fact that Germany has not yet implemented an integrated supervisory approach between its banking, insurance and securities sectors. An "umbrella type" of supervision exists here whereby these sectors operate functionally under one regulator, the Federal Financial Supervisory Office, Bundesanstalt fuer Finanzdienstleistungsaufsicht – BaFin. In addition to highlighting the importance of historical, cultural and economic factors in determining the structure of financial regulation across the four jurisdictions being investigated, this section considers the importance of a coherent and "truly integrated" approach in achieving stated supervisory objectives. The role of the central bank in supervision is also emphasised.

7.3.1 Germany

As far back as the early 1990s, the issue of financial conglomerates supervision had been prominent in various academic literature.[42] The objective of supervising such conglomerates was to capture effectively risks generated by various types of businesses and their associations.[43] In response to the blurring distinction between bank, insurance and investment sectors, many countries including Germany, have created a single financial services regulator. The rise of conglomerates has led to growing internationalisation of accounting and hence the growing importance of transparency and

41 C Nobes and R Parker, *Comparative International Accounting* at p 22

42 See Deutsche Bundesbank, 'Supervision of Financial Conglomerates in Germany' Monthly Report (April 2005) 47

43 ibid

increasing reliance on financial statements in countries such as Germany and Italy where fewer listed companies exist in comparison to the UK and the US.[44] At international level, the Joint Forum on Financial Conglomerates established in 1996, was created in response to the issue.[45] The Basel Committee on Banking Supervision (BCBS), the International Association of Insurance Supervisors (IAIS) and the International Organisation of Securities Commissions (IOSCO) work together within the Joint Forum.[46]

The lack of a significant body of private shareholders and public companies in countries such as Italy and Germany obviates the reduced role played by auditors in these jurisdictions when compared to such jurisdictions such as the UK and the US.[47] However there is growing realisation of the importance of audits in Germany and Italy in that the respective governments have recognised the importance of requiring public or listed companies to publish detailed, audited financial statements even though there are fewer listed companies when compared to the UK and the US.[48]

Today, prudential regulations in Germany are based to a great extent on international standards and on the Basel Capital Accord and the EC Directives in particular.[49] The *Deutsche Bundesbank* has been a member of the Basel Committee on Banking Supervision since its inception and also works with other international banking supervisory bodies such as the Banking Supervision Committee of the ESCB (the European System of Central Banks), the Banking Advisory Committee, Groupe de Contact, the International Organisation of Securities Commissions, the Financial Stability Forum and the Committee on the Global Financial System.[50]

7.3.2 Banking Supervision in Germany

Banking supervision in Germany is carried out by its central bank, the *Deutsche Bundesbank* in close collaboration with the Federal Financial Supervisory Office, *Bundesanstalt fuer Finanzdienstleistungsaufsicht* – BaFin). Prior to this present model, Germany had a separate agency, the *Bundesaufsichtsamt fuer das Kreditwesen* (BAK – federal banking supervisory office)

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44 C Nobes and R Parker, *Comparative International Accounting* p 20
45 See Deutsche Bundesbank, 'Supervision of Financial Conglomerates in Germany' Monthly Report (April 2005) 47
46 ibid
47 C Nobes and R Parker, *Comparative International Accounting* p 27
48 Ibid p 23
49 Deutsche Bundesbank's Involvement in Banking Supervision p 39
50 Ibid p 40

and supervision arrangements were not like those which existed then in the UK where supervision was organised as a department within the central bank, the Bank of England.[51] As with the Federal Banking Supervisory Office (*Bundesanstalt fuer Finanzdienstleistungsaufsicht* – BaFin), the *Bundesaufsichtsamt fuer das Kreditwesen* was also required to collaborate with the *Bundesbank* and relied on information from the *Bundesbank*.[52] The *Bundesbank* enjoys such independence that neither the government nor legislature are willing to grant it powers beyond those contained in the *Bundesbank* law.[53] The Bundesaufsichtsamt fuer das Kreditwesen enjoyed wide powers but was still controlled by the Ministry of Finance.[54] The Bank of England's relationship with the government, in contrast, was not clearly defined – even though it was nationalised in 1946, it still occupied an independent position between the market and the state.[55]

The Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht* - BaFin) was established on 1 May 2002 and the legal basis for its creation is the "Act Establishing the Federal Financial Supervisory Authority " (*Gesetz über die Bundesanstalt für Finanzdienstleistungsaufsicht - Finanzdienstleistungsaufsichtsgesetz* - FinDAG) of 22 April 2002.[56]

BaFin is an amalgamation of the three former Federal Supervisory Offices responsible for banking (the *Bundesaufsichtsamt für das Kreditwesen* - BAKred), the insurance industry (the *Bundesaufsichtsamt für das Versicherungswesen* - BAV) and securities trading (the *Bundesaufsichtsamt für den Wertpapierhandel* – BAWe). BaFin is a public-law institution with legal capacity reporting directly to the Federal Government and subject to the legal and functional supervision of the Federal Ministry of Finance.[57] It is funded entirely out of fees and contributions from the institutions and companies that it supervises and is independent of the Federal budget.[58]

BaFin was set up in response to global changes and developments within the financial services sector, fundamental changes which required a legislative response in order to secure the future

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[51] See HR Vieten, 'Banking Regulation in Britain and Germany Compared: Capital Ratios, External Audit and Internal Controls' (PhD thesis, London School of Economics 1996) 62, 63
[52] Ibid p 71
[53] Ibid pp 62, 63
[54] Ibid p 71
[55] ibid
[56] http://www.bafin.de/bafin/aufgabenundziele_en.htm#n1 (26 Dec 2007)
[57] ibid
[58] ibid

stability of the German financial system.[59]

The Banking Act *Gesetz ueber das Kreditwesen (Kreditwesengesetz* – KWG), is the legal basis for banking supervision in Germany and it aims at safeguarding the viability of the banking industry – which is particularly sensitive to fluctuations, by protecting creditors. The German Banking Act consists of six parts, each part subdivided into divisions. There are sixty – four sections covering the six parts of the Act (*Kreditwesengesetz* , KWG last amended through Article 5 of the law of 5th April 2004, BGBI.IS.502).

It is however interesting to note that the substantive law, the Banking Act (*Gesetz ueber das Kreditwesen*) was not replaced – as is the case with the UK where the Financial Services and Markets Act 2000 came into force, replacing previous banking legislation.

Section 6 of the Banking Act delegates the central role in banking supervision to the Federal Financial Supervisory Office. In addition to licensing, monitoring and (where necessary), closing individual institutions, the tasks of the Federal Authority also include issuing general instructions which lay down rules for carrying out banking business and providing financial services and for limiting risks.[60] It can do this by issuing principles and regulations.[61] The Federal Authority's duties also include resolving issues in the banking and financial services sector which could endanger assets entrusted to institutions, disrupt the orderly conduct of banking business or the orderly provision of financial services or lead to considerable problems for the economy as a whole.

The legislature provided for the *Bundesbank* to be involved in banking supervision having recognised that functions of the authority responsible for banking supervision and those of the central bank are interconnected.[62] Participation of the *Bundesbank* was considered necessary since the then Federal Banking Supervisory Office had no substructure of its own.[63] It was only the *Bundesbank* system, with its main offices and branch offices that permitted efficient and cost-effective supervision, at local level, of the over 4000 credit institutions in the Federal Republic of

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59 K Mwenda and J Mvula, 'A Framework for Unified Financial Services Supervision: Lessons from Germany and Other European Countries' (2003) 5 Journal of International Banking Regulation 37

60 <http://www.bundesbank.de/bankenaufsicht/bankenaufsicht_bafin.en.php>

61 ibid

62 T Filipova, ' Concept of Integrated Financial Supervision and Regulation of Financial Conglomerates : The Case of Germany and the UK' (2003) 1

63 ibid

Germany.[64]

There is clear division of functions between the Federal Financial Supervisory Office and the *Bundesbank* in the area of banking supervision.[65] When asked what made the German approach so special, Jochen Sanro, President of the Federal Banking Supervisory Office of Germany responded by saying: - The answer, of course, is the significant role the *Bundesbank* will play in banking supervision, and that is the reason, why I would like to call the new BaFin a 'modified' single regulator as compared to the British FSA, for example…-[66]

BaFin has 3 main objectives :[67]

To ensure the functioning of the entire financial industry in Germany. From this objective, 2 others can be inferred:

To safeguard the solvency of banks, financial services institutions and insurance undertakings

To protect clients and investors.

BaFin maintains that as a unified regulatory agency, it would be able to develop more effective rules in managing risk – as compared to all previous financial regulators.[68]

According to the Banking Act section 6, the objective of banking regulation is " ...to counteract undesirable developments in the banking and financial services sector which may endanger the safety of the assets entrusted to institutions, impair the proper conduct of banking business or provision of financial services or involve serious disadvantages for the economy..."[69] The insurance and securities industry also have their separate objectives.[70]

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64 ibid

65 ibid

66 Mwenda and Mvula, ' A Framework for Unified Financial Services Supervision' (2003) 5 Journal of International Banking Regulation 39

67 ibid p 37; Also see <http://www.bafin.de/bafin/aufgabenundziele_en.htm#n1>

68 ibid p 38

69 T Filipova (2006) 89

70 See VAG section 81 and WpHG section 41 respectively

7.3.3 Development of Banking Supervision in Germany

Since the introduction in Germany of general state banking supervision, the central bank the *Deutsche Bundesbank*, has played an integral role in supervision.[71] This prominent role has continued over the years and the Banking Act facilitates the *Bundesbank*'s participation in the monitoring of institutions[72]. One of the early examples of official banking regulation can be traced back to the Nuremberg Bancomat in 1621.[73] The Reichsbank was established in 1875 and proposals for state supervision of banks were discussed – however, these were abandoned.[74] This was so even though Germany had witnessed a series of bank failures over the past decades. The Rheinisch – Westfaelische Bank and the Vereinsbank Berlin failed in 1891 and the Dresdner Credit Anstalt and Leipziger Bank had collapsed in 1901.[75] As a result of the importance of credit institutions financing the German industrial revolution, the Reichsbank extended its powers from monetary policy to controlling the credit sector.[76] In 1931, the Austrian banking crisis extended to Germany and led to the collapse of Danatbank.[77] That same year, the banking crisis triggered the adoption of state supervision of all banks carrying out operations in Germany.[78] A banking supervisory body governing all the German banks was set up for the first time on September 19 1931 by the Emergency Decree of the Reich President on Companies Law, banking Supervision and Fiscal Amnesty.[79] In addition to specifying licensing criteria, the supervisory authority also arranged for regular monitoring of the banks.[80] The New York stock market crash of 1929, "Black Friday", had negative effects on the Great Depression which in turn, worsened the 1931 banking crisis.[81] Taking into consideration all the surrounding events, the German Reich's Government issued out various emergency decrees which included the Ordinance Governing Stock Corporation Law, Banking Supervision and Tax Amnesty in September 1931.[82] These became the foundation

71 See 'Bundesbank – Banking Supervision-Motives and Aims' < http://www.bundesbank.de/bankenaufsicht/bankenaufsicht_motive.en.php>

72 Deutsche Bundesbank, 'The Deutsche Bundesbank's Involvement in Banking Supervision' Monthly Report (September 2000) 31

73 See HR Vieten, 'Banking Regulation in Britain and Germany Compared: Capital Ratios, External Audit and Internal Controls' (PhD thesis, London School of Economics 1996) 57

74 ibid

75 See Vieten p 58

76 ibid

77 ibid

78 See 'History of Banking Supervision ' < http://www.bafin.de/bafin/historie_ba_en.htm>

79 Deutsche Bundesbank, 'The Deutsche Bundesbank's Involvement in Banking Supervision' Monthly Report (September 2000) 32

80 ibid

81 'History of Banking Supervision ' < http://www.bafin.de/bafin/historie_ba_en.htm>

82 ibid

for a uniform system of state supervision – applicable to all banks.[83] Prior to this, only particular groups[84] or targeted fields of banking[85] had been supervised.[86] Up till the start of the 1930s, Germany's banking sector had been operating in accordance with the principle of "*Gewerbefreiheit*", which meant the freedom of trade and commerce – which was of great importance in the German Industrial Code of 1869.[87] The occurrence of the 1931 German banking crisis led to the establishment of the emergency decree of September 1931 – its aim being the stabilisation of the whole financial sector.[88] A more detailed legislative framework for banking supervision was introduced as part of the Banking Act (*Kreditwesengesetz* – KWG) which was adopted on the 5th December 1934 and it superseded the Emergency Decree.[89] After World War II, banking supervision was at first carried out by the individual states within Germany's new federal system. There was no uniform regulatory framework till the Banking Act of July 10 1961 was passed.[90]

The years following the Second World War saw the Banking Act of 1934 amended in several instances. These amendments resulted from difficulties connected to the implementation of framework regulations, lack of clarity regarding certain areas of jurisdiction and proposals suggested by western allies.[91] The Banking Act of 1939 gave powers of prudential responsibilities to the Reich Banking Supervisory Office which reported directly to the Reich Minister of Economics.[92] The *Bundesbank* was established as an independent monetary body in 1957 – with the establishment of the *Bundesausichtsamt fuer das Kreditwesen* (BAK) following in 1961.[93] After many years of work, Germany's new "*Gesetz ueber das Kreditwesen*" (Banking Act version of 10 July 1961) was eventually adopted on 1 January 1962.[94] This Act was aimed at fostering order within the financial system at a general level whilst preserving the efficiency and stability of the

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[83] ibid
[84] Public savings banks in Prussia since 1838 - as well as mortgage banks since 1899 ; ibid
[85] Those under the Safe Custody Act and the Exchange Act of 1896; ibid
[86] ibid
[87] ibid
[88] ibid
[89] ibid
[90] See ' Development of Banking Supervision after the Second World War ' , < www.law.nyu.edu/centralbankscenter/texts/ Deutsch_Bundesbank_Banking_Act >
[91] See 'History of Banking Supervision' < http://www.bafin.de/bafin/historie_ba_en.htm>
[92] Deutsche Bundesbank, 'The Deutsche Bundesbank's Involvement in Banking Supervision' Monthly Report (September 2000) 32
[93] Vieten at pg 58
[94] See 'History of Banking Supervision' < http://www.bafin.de/bafin/historie_ba_en.htm>

financial sector.[95] The Banking Act of 1961 resulted in responsibility for banking supervision becoming centralised once again – after decentralisation had occurred by the Western military governments after the end of the Second World War.[96] Despite opposition by a number of Bundeslaender as to the concentration of banking supervisory powers within a single federal body, the Federal Constitutional Court ruled that the Banking Act was in accordance with the provisions of the Basic Law, *Grundgesetz,* in June 1962.[97] The Federal Banking Supervisory Office was granted sovereign responsibility with the Act making provision for the *Bundesbank* participation in the monitoring of credit institutions.[98] The Sixth Act Amending the Banking Act of 1997 broadened the scope of the *Bundesbank*'s involvement in prudential supervision to embrace the monitoring of financial services institutions.[99]

The First Act Amending the Banking Act brought about minor changes – however, undertakings subject to official supervision and sections relating to supervisory jurisdiction were gradually expanded.[100] Following the Second Act Amending the Banking Act and its adoption on 1 May 1976, the Federal Banking Supervisory Office was authorised to issue a moratorium on a bank considered to be in jeopardy[101] or request for an audit to be undertaken without special reason.[102] Other amendments included the adoption of internal control mechanisms and more thorough provisions regarding large exposures.[103] It has been said that this amendment of the Banking Act was prompted after weaknesses within the bank supervisory process became apparent – following the failure of Herstatt Bank in 1974.[104] After the collapse of Herstatt Bank, the law was changed to

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95 Deutsche Bundesbank, 'The Deutsche Bundesbank's Involvement in Banking Supervision' Monthly Report (September 2000) 32

96 ibid

97 See 'History of Banking Supervision' < http://www.bafin.de/bafin/historie_ba_en.htm> Some of the Laender had argued that establishing a superior Federal authority was unconstitutional due to the fact that it was not provided for by Article 87(3) sentence 1 of the Constitution. However, the Federal Constitutional Court ruled on July 24 1962 that the Banking Act was actually consistent with the Constitution. It observed further that the functions which the Banking Act delegated to the Bundesbank pursuant to Article 88 of the Constitution was within its operational jurisdiction as a central bank. In explaining its decision further, the Court stated that the central bank had always been involved in banking supervision and that issues of monetary policy and banking supervision were linked. See Deutsche Bundesbank, 'The Deutsche Bundesbank's Involvement in Banking Supervision' Monthly Report (September 2000) 33

98 Deutsche Bundesbank, 'The Deutsche Bundesbank's Involvement in Banking Supervision' Monthly Report (September 2000) 32,33

99 Ibid p 33

100 See 'History of Banking Supervision' < http://www.bafin.de/bafin/historie_ba_en.htm>

101 Section 46a KWG

102 Section 44(1) KWG; ibid

103 Ibid; For internal control mechanisms, see section 33 KWG and large exposures, section 13 KWG.

104 See 'Bundesbank – Banking Supervision-Motives and Aims' <http://www.bundesbank.de/bankenaufsicht/bankenaufsicht_motive.en.php>

allow German regulators to commission special reports without specific reasons.[105]

In addition to considering extensive revision of the Banking Act and establishing a Commission of Inquiry into “Basic Banking Questions” for this purpose in November 1974, the Federal Ministry of Finance also examined whether the framework of the German banking system should be reformed.[106] It was held in its report submitted in May 1979, that even though the German banking system had proved efficacious, adjustments would have to be made to the Banking Act to reflect changes in the credit institutions' risk position.[107] In addition to concluding that findings of the inquiry were in line with the demands which the banking supervisory authorities had been making in the light of their practical experience, the issue of ensuring that individual institutions and groups of institutions had adequate capital had to be addressed.[108]

The Third Act Amending the Banking Act upon its coming into force on 1 January 1985, introduced a consolidation process for prudential purposes in addition to the existing supervision of individual credit institutions.[109] The Third Act Amending the Banking Act was also based on a report published by the Inquiry Commission established after the collapse of Herstatt, regarding basic issues within the banking sector, “*Grundsatzfragen der Kreditwirtschaft*”.[110] Around the end of 1992, the Fourth Act Amending the Banking Act led to transposition of the Second Banking Coordination Directive and the Directive on the Own Funds of Credit Institutions into German law.[111]

As well as re defining the concept of own funds, the Fourth Act Amending the Banking Act also introduced the principle of shareholder monitoring and placed restrictions on non-bank ownership interests.[112] The Fifth Act Amending the Banking Act was adopted in September 1994 and saw the transposition of the Large Exposure Directive and the Second Consolidation Directive into German

105 See Deutsche Bundesbank, *Geschaeftsbericht* (1974) 68

106 See 'Bundesbank – Banking Supervision-Motives and Aims' <http://www.bundesbank.de/bankenaufsicht/bankenaufsicht_motive.en.php>

107 ibid

108 ibid

109 Ibid; Till then, credit institutions could build up credit pyramids through their subsidiaries without any increase in the parent institution's capital base, thereby bypass ing the limits on business operations that were based on the credit institutions' capital.

110 See 'History of Banking Supervision' < http://www.bafin.de/bafin/historie_ba_en.htm>

111 Ibid; Also see Deutsche Bundesbank, 'The Fourth Act Amending the Banking Act – A Further Step Towards the European Banking Market' Monthly Report (January 1993)

112 ibid

law.[113] Further amendments, the most recent being the Sixth Act Amending the Banking Act as of 1 January 1998, served to implement Directives of the European Union and thereby harmonise banking supervision legislation in the European Economic Area (EEA).[114] These have resulted to legal conditions being created for the freedom of banking activities and financial services within the single European market.[115]

In September 2001, the Federal Ministry of Finance published a first draft of the Fourth Financial Markets Enhancement Act.[116] A new draft Act then followed in 2002 – the purpose of this Draft Act being the improvement of the protection of private investors and to help extend the scope of capital market activities in Germany.[117] It does not completely codify financial markets laws but amends present laws – including the German Banking Act.[118] Amendments to the German Banking Act include:[119] The issue of credit cards and traveller cheques (given that the issuer is not at the same time the offeror of the services paid for through such instruments) being subject to a licence requirement; " e money business" becoming subject to a banking licence requirement; the powers of German regulatory authorities being extended in a number of areas to give full effect to the Basel Core Principles for Effective Banking Supervision 1997.

The measures in the Fourth Financial Market Promotion Act (" the Act") consider the impact of international standards in banking supervision.[120] The Act also brings the present law in alignment with major technological developments, particularly within the banking and financial services sectors.[121] The Fourth Financial Market Promotion Act also implements the EC E Money Directive and facilitates the increased use of online and internet banking.[122]

On the 1st January 2004, an entirely new Investment Act and a new Investment Tax Act came into

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113 Ibid; See also Deutsche Bundesbank, 'The Fifth Act Amending the Banking Act' Deutsche Bundesbank Monthly Report (November 1994)

114 See 'Bundesbank – Banking Supervision-Motives and Aims' <http://www.bundesbank.de/bankenaufsicht/bankenaufsicht_motive.en.php>

115 Ibid ; also see Deutsche Bundesbank, 'The Sixth Act Amending the Banking Act' Monthly Report (January 1998)

116 P Scherer, 'Regulatory Changes Proposed in Germany' 2002 (2) Journal of International Banking Law 29

117 ibid

118 ibid

119 ibid at p 31

120 A Steck and C Loosen, 'New Legislation to Reform and Enhance Germany's Status as a Financial Centre' 2002 (9) Journal of International Banking Law 274

121 ibid

122 ibid at p 275; Also see Deutsche Bundesbank, 'Amendments to the Banking Act caused by the Fourth Financial Market Promotion Act 2002' Monthly Report October 2002

operation in Germany.[123] This Act not only implements the amended UCITS (Undertakings for Collective Investment in Transferable Securities), but also implements innovations such as hedge funds in order to increase the competitiveness of Germany as an international financial market centre.[124] One of the reasons prompting this near complete revision of the German investment law was the need to implement the amended UCITS Directive by February 13 2004.[125] The new Investment Act covers what was governed by the previous Investment Companies Act and the Foreign Investment Act with exception of the tax provisions of the Foreign Investment Act which are within the Investment tax Act.[126] Improved clarity is one of the features of the structure of the new Investment Act and the new Investment Tax Act – however the taxation provisions of the new Investment Tax Act are still ambiguous.[127]

Unlike other European investment companies, German investment companies, being credit institutions, are subject not only to the provisions of the Investment Act, but also to the Banking Act.[128] German investment companies are obliged to manage investment funds solely in the unit holders' interests and the objective of protecting the integrity of the markets is now clearly stated in the Investment Act.[129] Investment companies must also provide BaFin with information on asset portfolio and specified information on all securities and derivatives in order to facilitate supervision of compliance by BaFin.[130] According to the Investment Act, outsourcing by an investment company is only allowed if basic requirements for outsourcing under the Banking Act are met and if delegation does not restrict the investment company from acting in the unit-holders' interests.[131]

The new Investment Act undoubtedly signifies a significant change for the German investment industry since the Investment Companies Act first regulated investment funds in 1957.[132] The flexibility demonstrated by the new law whilst striving to achieve the objective of investor

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123 See T Paul, 'The New German Investment Act' 2004 (4) Journal of International Banking Law and Regulation 136
124 ibid
125 ibid
126 ibid
127 ibid
128 ibid
129 ibid p 137
130 ibid
131 ibid
132 Ibid p 142

protection, has been applauded.[133]

Whilst some single financial services regulators in countries like Denmark are not closely associated to their central bank operations, the UK cooperates with its central bank, exchanging information through a Memorandum of Understanding. As stated by Llewellyn, any country setting up the structure of a regulatory system, should consider such factors as the necessary number of agencies, the appropriate structure of those agencies, how the objectives for each agency should be defined, the degree of coordination and information haring between different agencies, the independence and accountability of the regulatory agencies and other factors.[134] Historical factors should also be considered.

7.3.4 Reasons for Creation of a Unified Services Regulator in Germany.

Reasons for integrated financial market supervision include:[135]

> The growth of financial conglomerates. The regulator is challenged in having to capture risks arising from cross-shareholdings and intra-group transactions within conglomerates;
>
> The increasing integration of the financial markets requires a holistic view of the system which can be provided only by an integrated financial supervisory authority;
>
> Banking; insurance and investment groups compete for the savings of private households with similar or even identical products.

Even though financial services has been brought under one roof, BaFin still recognises the differences which exist between the industries and the government did not amend the substantive law[136] forming the basis of the three previously separate areas.[137] In addition, BaFin's organisational structure also recognises these industry differences.[138]

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133 ibid

134 See D Llewellyn, 'The Creation of a Single Financial Regulatory Agency in Estonia : The Global Context' Paper Presented at Conference Organised by the World Bank and the Ministry of Finance of Estonia, 2001 at p 4

135 <http://www.bafin.de/bafin/aufgabenundziele_en.htm#n1>

136 Namely the Banking Act (Kreditwesengesetz – KWG), the Insurance Supervision Act (Versicherungsaufsichtsgesetz – VAG) and the Securities Trading Act (Wertpapierhandelsgesetz – WpHG); ibid

137 ibid

138 ibid

7.3.5 Collaboration between the Federal Ministry of Finance, the Deutsche Bundesbank and the Federal Financial Supervisory Authority.

At first, it might seem that collaboration within the German Banking Act is a two way affair between the Federal Financial Supervisory Authority and the *Deutsche Bundesbank*. However, the Federal Ministry of Finance is involved in various consultations with the *Deutsche Bundesbank* and also delegates, in various instances, certain duties to the Federal Financial Supervisory Authority. In carrying out and delegating certain duties, the Federal Ministry of Finance usually does so by way of a regulation.

7.3.5.1 Collaboration relating to definitions within the German Banking Act

Under section 1 (3) KWG, the Federal Ministry of Finance, the Bundesfinanzministerium, consults with the *Deutsche Bundesbank* and after doing so, may designate certain enterprises as financial enterprises by way of a regulation. According to section 1 (12), and in order to determine the definition of the trading book, the Federal Ministry of Finance also consults with the *Deutsche Bundesbank* and after this, may issue more detailed provisions regarding the definition of the trading book by way of a regulation. The Federal Ministry of Finance may, by way of a regulation, also delegate this authority to the Federal Financial Supervisory Authority provided that the regulation is issued in agreement with the *Deutsche Bundesbank*.

7.3.5.2 Collaboration relating to exemptions from certain provisions of the Banking Act and the issue of more detailed provisions in relation to sections of the Act.

The Federal Ministry of Finance is also authorised to permit, by way of regulation and without requiring consent of the Upper House of Parliament (the Deutscher Bundesrat) exemptions from certain obligations for individual payment types and individual payment systems. The Federal Ministry of Finance may by way of delegation, also delegate this authority to the FFSA (section 25 b (4) KWG.

According to Division 7, section 31 of the KWG, the Federal Ministry of Finance, after consulting with the *Deutsche Bundesbank*, may by way of a regulation, exempt all institutions or certain types/classes of institutions from the duty to report specific exposures and facts. It may also delegate this authority to the FFSA, by way of a regulation - so far as the regulation is issued in consultation with the *Deutsche Bundesbank*.

In relation to the special duties of the auditor, the Federal Ministry of Finance, in agreement with the Federal Ministry of Justice (*Bundesministerium der Justiz*) and after consulting with the *Bundesbank*, may issue more detailed provisions on the object of an audit, the time at which it is carried out and the contents of auditors' reports by way of regulation (Section 29 (4) KWG). This is so far as it is necessary for the performance of the FFSA's duties and also particularly to enable it identify inconsistencies which may endanger the assets entrusted to the institution or which may affect proper execution of banking business or provision of financial services and to obtain consistent records for assessing the business conducted by institutions. It may also delegate this authority to the FFSA.

Under section 2(5) of the KWG, the Federal Financial Supervisory Authority may decide in certain cases, after consulting with the *Deutsche Bundesbank*, that an enterprise which mainly carries out e money business is not subject to certain sections of the German Banking Act. Such ruling is published in the Federal Gazette. The Federal Ministry of Finance, after consulting with the *Deutsche Bundesbank*, may by way of a regulation, issue more comprehensive provisions regarding conditions whereby such exemption from the Banking Act may be granted. The Federal Ministry of Finance could also by way of a regulation, delegate this authority (the issue of more detailed provisions) to the FFSA provided that the regulation is issued in agreement with the *Bundesbank*. In a way, this tripartite arrangement is comparable to that which exists in the UK between the FSA, the Bank of England and the Treasury. However, there is a more direct relationship between the Federal Financial Supervisory (FFSA) and the *Deutsche Bundesbank*.

7.3.6 Functions of the Federal Financial Supervisory Authority

The Banking Act of 1961 transferred responsibilities for the monitoring of credit institutions and with the coming into force of the Sixth Act Amending the Banking Act, the monitoring of financial services institutions as well, to the Federal Banking Supervisory Office (now known as the Federal Financial Supervisory Authority).[139] The Federal Banking Supervisory Office reported directly to the Minister of Economics and since 1972, to the Federal Ministry of Finance.[140]

In addition to deciding whether certain enterprises are bound by the provisions of the German Banking Act (section 4 KWG), the FFSA also:

[139] Deutsche Bundesbank 'The Deutsche Bundesbank's Involvement in Banking Supervision' Monthly Report (September 2000) 34
[140] ibid

supervises institutions pursuant to the provisions of the German Banking Act (Division 2, section 6 (1))

Seeks to prevent developments within the banking and financial services sector which may endanger the safety of assets under the control of institutions, affect the proper conduct of banking businesses or lead to serious advantages for the economy of the nation (Division 2, section 6 (2))

Issues orders to institutions and their managers in order to prevent violations of regulatory provisions, to prevent incidences which could endanger the safety of assets entrusted to an institution or prevent incidences which could affect the proper conduct of its banking business or provision of financial services (Division 2, section 6 (3).

7.3.7 Division 3. Information and Audits

Section 44 involves information from and audits of institutions, ancillary banking services enterprises, financial holding companies and enterprises included in supervision on a consolidated basis.

Upon request, an institution, members of its governing bodies, its employees are required to provide information to the FFSA, to agencies and persons used by the FFSA in carrying out its functions and to the *Bundesbank* about all business activities and also submit documentation (section 44 (1)). The FFSA may perform audits at the institutions without special reason and may entrust the *Deutsche Bundesbank* with the duty of carrying out these audits. Staff of the FFSA, the *Deutsche Bundesbank* and other persons used by the FFSA to carry out its audit may enter and inspect the institution's business premises during usual business hours. (note: basic right within the *Grundgesetz* is not restricted to this extent. However, when prosecuting unauthorised banking business and financial services (section 44c), basic right restricted).

Those enterprises domiciled abroad which are part of a group are to allow the FFSA carry out audits upon request from the FFSA – particularly those checks relevant to the accuracy of the consolidated accounts (section 44 (3) KWG).

Under section 44 (4) KWG, the FFSA is empowered to send representatives to shareholders' meetings, general meetings or partners' meetings, meetings of the supervisory bodies of institutions organised in the form of a legal person.

In relation to prosecution of unauthorised banking business and financial services, section 44c (1) KWG requires an enterprise whose facts are known to point to the assumption that it carries out banking business or provides financial services without licence required by the KWG or that it carries out business prohibited under section 3 of the KWG, to provide information on the business activities of the enterprise. The enterprise is also required to give documentation to the FFSA and the *Deutsche Bank*.

The FFSA has the power to carry out inspections on the enterprises's site and on the premises of any persons and enterprises required to provide information and documentation and it may entrust to the *Deutsche Bundesbank* the duty of performing such inspections (section 44c (2) KWG). For this purpose, the FFSA and the *Deutsche Bundesbank* are empowered to enter and inspect these premises during usual customary business hours. In order to avoid apparent risks to public order and safety, they are also authorised to enter and inspect the premises also outside customary office and business hours and can also enter and inspect areas serving as residential quarters. As a result, the basic right contained within Article 13 of the Constitution (Grundgesetz) is restricted to this extent. Under section 44c (3), staff of the FFSA and the *Deutsche Bundesbank* are empowered to carry out searches on the premises of the enterprise and of the persons and enterprises required to provide information and present documentation to subsection (1) sentence 1 of section 44c. The basic right contained within Article 13 of the Constitution is restricted to this extent and searches of business premises require a judicial warrant except in the cases of imminent risk. Staff of the FFSA and the *Deutsche Bundesbank* are allowed to safe keep items which could be of importance as evidence in their investigations (section 44c (4)).

7.3.8 The Bundesbank's Involvement in Banking Supervision

The *Bundesbank* has extensive knowledge of the financial sector, well-trained, qualified staff with expertise due to its business relationships with credit institutions, its local presence and general proximity to the market.[141] Parliament therefore had good reasons for involving the *Bundesbank* through section 7 of the Banking Act in the banking supervision process.[142] The *Bundesbank* is involved in basically all aspects of banking supervision and these include:[143] The issuing of general

141 Deutsche Bundesbank, 'The Deutsche Bundesbank's Involvement in Banking Supervision' Monthly Report (September 2000) 34
142 ibid
143 ibid

rules such as principles and regulations; undertaking regular surveillance which excludes sovereign and isolated measures directed at institutions – as these are reserved for the Federal Financial Supervisory Authority; banking supervisory audits; ongoing monitoring of institutions; international cooperation in coordination of prudential matters and crisis management roles.

Functions performed through collaboration between the Federal Financial Supervisory Authority (FFSA) and the *Deutsche Bundesbank* comprise:

Ongoing monitoring of institutions by the *Deutsche Bundesbank*. This involves the evaluation of documents submitted by institutions; auditors' reports pursuant to section 26 KWG, annual financial statements, as well as performing and evaluating audits of banking operations in order to assess the adequacy of institutions' capital and risk management procedures and the appraisal of audit findings (Division 2, Section 7 of KWG). Ongoing monitoring of institutions are to be performed by the *Bundesbank*'s regional offices. Collaboration with the FFSA is involved in the monitoring performed by the *Bundesbank* as the *Bundesbank* is required to observe guidelines issued by the FFSA. The guidelines are also issued in agreement with the *Deutsche Bundesbank*. If no agreement can be reached within a certain period, the Federal Ministry of Finance issues guidelines in consultation with the *Deutsche Bundesbank* (section 7 (2) KWG.

The FFSA and the *Deutsche Bundesbank* are to communicate to each other any observations and findings deemed necessary for the performance of their duties (Section 7 (3) KWG. Against this background, the *Bundesbank* is required to provide the FFSA with information it obtains through the collection of statistics pursuant to section 18 of the *Bundesbank* Act (Gesetz *ueber die Deutsche Bundesbank)*. Before ordering the collection of statistics, the *Bundesbank* is required to consult with the FFSA (section 18 sentence 5 of the *Bundesbank* Act) where necessary.

The FFSA and the *Bundesbank* may also permit each other access to their respective database in order to carry out their duties under the German Banking Act (section 7 (4). Where the FFSA obtains personal data from the *Deutsche Bundesbank'*s database, every tenth time, the *Bundesbank* is required to log the time and details which allow the obtained data to be identified and the identity of the person obtaining the data.

The FFSA and the *Bundesbank* may also set up joint data files. When supervising institutions which carry out banking business or provide financial services in another state of the European Economic Area, and when supervising institutions pursuant to the Banking Directive, the FFSA and so far as it is acting under the German Banking Act, the *Bundesbank* are required to cooperate with respective authorities of the state involved (Division 2, Section 8 (3) KWG).

Institutions are required to submit monthly returns to the *Deutsche Bundesbank* immediately after the end of every month. The *Bundesbank* also passes on monthly returns with its comments to the FFSA and the FFSA may waive its right to receiving certain monthly returns (section 25 KWG).

Further evidence of close working relationship between the FFSA and the *Deutsche Bundesbank* can be seen under sections 26, 28, 29, 44, 44c of the German Banking Act.

Under section 2 (10), change in a financial services institution's circumstances should be reported to the FFSA without delay. The FFSA then forwards these reports to the *Bundesbank*. Other circumstances exist whereby an institution is required to report certain activities to the FFSA and the *Bundesbank*. These include: i) The acquisition of qualified participating interests in an institute (section 2b (1) KWG.; (ii) Where the holder of a qualified participating interest intends to increase the amount of the qualified participating interest in such a way that the thresholds of 20%, 33% or 50% of the voting rights or capital are reached or exceeded, or that the institution comes under his control.

7.3.9 Confidentiality

Employees of the FFSA and anyone commissioned under section 4 (2) of the Act on integrated financial services (Gesetz zur Errichtung der Bundesanstalt fuer Finanzdienstleistungsaufsicht), supervisors appointed under section 46 (1) sentence 2 number 4, liquidators appointed under section 37 sentence 2 and section 38 (2) sentences 2 and 4 and employees of the Deutsche *Bundesbank*, insofar as they are involved in implementing the German Banking Act are under obligation not to disclose or use without authority, information and facts which have come to their observation during the course of their duties and which should be kept secret in the interests of the institution or a third party (especially business and trade secrets) - not even after they have left such employment or their activities have ended (section 9 KWG). The same applies to other persons who learn of such facts or information as a result of official reports.

Such facts are deemed not to be disclosed or of use without authorisation if they are passed:

To public prosecutors' offices or courts having jurisdiction in criminal cases and administrative fine cases;

To agencies which as a result of a parliamentary act or public mandate, are entrusted with supervision of institutions and other stated enterprises and to persons commissioned by such agencies;

To agencies dealing with an institution's liquidation or the commencement of insolvency proceedings over its assets;

To persons in charge of statutory audits of accounts of institutions or financial enterprises and to agencies supervising such persons;

To a deposit guarantee scheme or an investor compensation scheme;

To stock markets or financial futures exchanges or

To central banks

Insofar as these agencies require the information for the performance of their functions. In the case of a foreign agency, the agency is to be made aware that it may use information solely for the purpose for which it has been passed on to it.

Submission of Annual Accounts, Management Report and Auditor's Reports

In addition to an institution being required to submit its approved annual accounts, approved management report to the FFSA and the *Deutsche Bundesbank* without delay, pursuant to Division 5a, section 26 of the KWG, the auditor is also required to submit his report on the auditing of the annual accounts (auditor's report), to the FFSA and the *Bundesbank* without delay upon completion of the audit.

In relation to credit institutions belonging to a credit cooperative audit association or audited by the audit office of a savings bank and giro association, the auditor submits the audit report only upon request by the FFSA (KWG 26 (1). Audit reports on supplementary audit carried out in association with a guarantee scheme and audits on group accounts are to be submitted by the auditor to the FFSA and the *Bundesbank* without delay upon completion of the audit (Section 26 (

2, 3) KWG).

Auditors Appointed in Special Cases

Institutions are to inform the FFSA and the *Bundesbank* of their appointed auditors immediately after the appointment has taken place. Within one month of receiving this information, the FFSA may order the appointment of another auditor if this is necessary in order to attain the aim of the audit (section 28(1)). The court of registration having jurisdiction of the institution shall then appoint an auditor upon request of the FFSA (section 28 (2)) subject to certain conditions under this section of the Act.

Special Duties of the Auditor

In addition to auditing the annual or interim accounts of a financial institution, the auditor is also required to examine its financial circumstances (section 29(1)). Compliance with reporting requirements, obligations under the Money Laundering Act, section 128 of the Companies Act on disclosure requirements and section 135 of the Companies Act are to be included in the auditor's report - with some items being reported separately in the report (section 29 ss1,2 KWG).

If during the course of his audit the auditor discovers information which may lead to the audit being qualified or lead to the certificate of audit being withheld, jeopardise the existence of the institution or seriously disrupt its progress or which indicates that managers have seriously disregarded the law or the Articles of Association or the partnership agreement, he is to report this immediately to the FFSA and the *Deutsche Bundesbank* (section 29 (3)). Upon request from the FFSA or the *Bundesbank*, he shall provide them the auditor's report and communicate any other facts obtained during the course of the audit which may suggest that the institution's business affairs have not been conducted properly. Provided he reported in good faith, the auditor would not be held accountable for accuracy of facts relating the information provided.

7.3.10 The Deutsche Bundesbank's Responsibilities

The *Bundesbank*'s involvement in banking supervision arises not only from historical evolution but also from the nature of its duties.[144] As a result of its business relationships with credit institutions, its local presence and its general proximity to the market, the *Bundesbank* has deep insights into the

[144] <http://www.bundesbank.de/bankenaufsicht/bankenaufsicht_bafin.en.php> (15 July 2006)

financial sector and possesses knowledgeable, qualified staff who deal with issues relating to the financial market and its stability.[145] It is therefore not surprising that the German Parliament approved the *Bundesbank*'s involvement in banking supervision in section 7 of the Banking Act.[146]

The *Bundesbank* is assigned most of the operational tasks in banking supervision and the functional effectiveness of the supervisory system is essentially backed, in particular, by the *Bundesbank*'s many years and expertise in the field of financial markets and payment operations.[147] The *Bundesbank*'s responsibilities notably include evaluating the documents, reports, annual accounts and auditors' reports submitted by the institutions as well as regular audits of banking operations.[148] There is clear division of responsibilities between the Federal Financial Supervisory Office and the *Bundesbank* as regarding banking supervision.[149] The Federal Financial Supervisory Authority, being successor to the Federal Banking Supervisory Office, is responsible for all sovereign measures.[150] Sovereign functions include such functions as the issuing of administrative acts. Only in exceptional cases will the FFSA carry out audits of banking operations, either together with the *Bundesbank* or on its own.[151]

Before issuing general regulations, the Federal Financial Supervisory Authority must consult with the *Bundesbank*.[152] The extent of the *Bundesbank*'s participation in the supervisory process is graded according to the level to which those regulations affect its functions.[153] Through this involvement in supervising individual institutions, the *Bundesbank* also acquires knowledge about the solvency of its own borrowers which it needs for its central bank functions.[154] This in turn contributes to the stability of the financial system - also in the framework of the European System of Central Banks (ESCB).[155] In fact, a considerable shift in emphasis has been apparent during the

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145 ibid
146 ibid
147 <http://www.bundesbank.de/bankenaufsicht/bankenaufsicht_bafin.en.php>
148 ibid
149 See <http://www.law.nyu.edu/centralbankscenter/texts/Deutsch_Bundesbank_Banking_Act.html>and also <http://www.iuscomp.org/gla/statutes/KWG.htm> For more updated version of the Act , see <http://www.bundesbank.de/download/bankenaufsicht/pdf/kwg_e.pdf>
150 <http://www.bundesbank.de/bankenaufsicht/bankenaufsicht_bafin.en.php>
151 ibid
152 See <http://www.law.nyu.edu/centralbankscenter/texts/Deutsch_Bundesbank_Banking_Act.html> and also <http://www.iuscomp.org/gla/statutes/KWG.htm>
153 ibid
154 <http://www.bundesbank.de/bankenaufsicht/bankenaufsicht_bafin.en.php>
155 ibid

past few years towards strengthening the stability of the financial system.[156] The *Bundesbank* plays an important role in virtually all areas of banking supervision as follows:[157]

the issuing of general rules (such as principles and regulations);

the process of ongoing supervision, with the exception of (sovereign) individual regulatory measures vis-à-vis institutions, which are reserved for the Federal Agency

prudential audits and

international cooperation/coordination in the prudential field.

In addition, the *Bundesbank* plays an important role in crisis management.[158] The *Bundesbank*'s tasks are set out in the *Bundesbank* Act and in the EC Treaty.

Article 3 of the Memorandum of Understanding explains[159] the responsibilities of the main offices of *Bundesbank* in analysing banking business documents and notifying BaFin of the results of the analysis. The *Deutsche Bundesbank* also studies the auditor's report and has more control over bank audits.[160]

Audits of Credit Institutions

The banking supervisory process relies substantially on the credit institutions' data – hence dependence on the use of auditors. Even though the *Bundesbank* has its own banking supervisory auditors (approximately 70 as of September 2000), these also conduct trading activities on behalf of the Federal Financial Supervisory Office as well as audits to determine the adequacy of institutions' market risk models.[161] As a result, the use of external auditors is of great importance. Credit institutions are audited by independent certified auditors whom they select themselves and who, in their audits, have to comply with detailed auditing guidelines laid by the Federal Banking Supervisory Office. Section 29 lists duties of the auditors.

[156] ibid
[157] ibid
[158] ibid
[159] Page 25
[160] Banking business audits are normally carried out by the Bundesbank : see Articles 6 and 7 of the Memorandum of Understanding.
[161] Bundesbank's Involvement in Banking Supervision Monthly Report September 2000 p 37

7.4 Italy

7.4.1 Banking Regulation and Supervision in Italy

Financial regulation and supervision is undertaken by Italy's six financial regulators namely: The Bank of Italy (*Banca d'Italia*) – the central bank; CONSOB (*Commissione Nazionale per le Societa e la Borsa*) – the Italian Securities and Exchange Commission; the UIC (*Ufficio Italiano dei Cambi*) The Antitrust Authority; the CICR (*Comitato Interministeriale per il Credito ed il Risparmio*,Isvap (*Istituto per la vigilanza sulle assicurazioni private e di interesse collettivo*) and Covip (*Commissione di vigilanza sui fondi pensione*). Banking regulation and supervision in Italy has always been the function of the central bank. Even though the 1926 and 1936 Banking Laws actually created a separate banking inspectorate, this was headed by the Governor of the Bank of Italy and staffed by the personnel of the Bank.[162] The supervisory function was transferred back to the Bank in 1947. The Italian Securities and Exchange Commission, Commissione Nazionale per le Societa e la Borsa (CONSOB) was established in 1974 through regulation L.216/1974. This is the very same law that led to the establishment of several decrees which set out the fundamental regulations of the capital market.[163] CONSOB shares regulatory responsibilities with the Bank of Italy. Whilst the Bank focuses on financial stability, the prudential supervision of banks, financial companies and investment firms, CONSOB which is similar to the US SEC, is in charge of transparency and investor protection. As a result, it not only has regulatory powers over companies as issuers of securities but also over banks and investment firms as providers of investment services to the public.[164] The Antitrust Authority, the most recently created of the financial bodies, aims to guarantee a free market[165] and also to prevent malfunctions and bias of the capital market and the market in general. Separate supervisors such as Isvap and Covip regulate and supervise the insurance and pensions industries respectively. The financial regulators are distinguished from the credit authorities which comprise of the Interministerial Committee for Credit and Savings, the Minister of the Treasury and the Bank of Italy.[166]

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162 G Carosio, 'Italy,Europe and Financial Regulation' <http://www.ox.ac.uk/**g**azette/2002-3/weekly/101002/lecs.htm >; also <http://users.ox.ac.uk/~hine/seminarpapers/Carosio.htm>

163 Fundamental regulations of the capital market include financial statements, formats and requirements, mandatory auditing for listed companies etc.

164 G Carosio, 'Italy,Europe and Financial Regulation' <http://www.ox.ac.uk/**g**azette/2002-3/weekly/101002/lecs.htm >; also <http://users.ox.ac.uk/~hine/seminarpapers/Carosio.htm>

165 See S Delaney, 'Parmalat Spurs Call for Reform in Business: Italian Government Plans To Strengthen Oversight' *The Washington Post* (January 20 2004) http://www.washingtonpost.com last visited 20 July 2007

166 See Article 1(a) of the 1993 Banking Law

7.4.2 Banking Objectives in Italy

The objectives of supervision – sound and prudent management of intermediaries and the overall stability, efficiency and competitiveness of the financial system – were established expressly with the Bank of Italy being required to give prior public notice of the principles and criteria of its supervisory activity, and its regulatory powers were redefined with reference to banking risks.[167] Because the Bank of Italy's objectives involve the general interest, it is afforded great powers of institutional and operational independence and it can use these in its pursuit of monetary and financial stability.[168] As the state has no share in the Bank's capital and is not represented in the Bank's governing organs, this facilitates the Bank's independence from political interference.[169] The Bank of Italy is however subject to ministerial supervision by an Inspectorate General which audits the Bank's annual accounts.[170] The Minister of Treasury also has powers of supervision and has to authorise changes affecting the Bank's branches after approval by the Board of Directors and approve guidelines for the investment of the Bank's reserves.[171]

7.4.3 Historical Background of the Italian Banking System

Banking in Italy dates back as far as the fourteenth century.[172] In 1861, when Italy's new Parliament decreed the unification of Italy, there were just about six banks of issue and although unification embraced a wide range of activities, these did not include the issue of bank notes.[173] The six banks of issue included *Banca Nazionale nel Regno d'Italia*, *Banca Nazionale Toscana*, *Banca Toscana di Credito per le Industrie e il Commercio d'Italia*, *Banca Romana*, *Banco di Napoli* and *Banco di Sicilia*.[174]Towards the end of the century, a serious bank crisis, in which *Banca Romana* was involved, led to a radical reorganisation of the banking system and in 1893, the Bank of Italy was created through a merger of three of the six existing banks of issue.[175] *Banca Romana* was wound up whilst *Banco di Napoli* and *Banco di Sicilia* continued to issue notes until 1926 when the Bank

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167 Carosio, 'Italy, Europe and Financial Regulation'

168 'The Origins of the Bank of Italy' Bank of Italy Representative Office for Japan

169 ibid

170 ibid

171 ibid

172 F Carnevali, British and Italian Banks and Small Firms : A Study of the Midlands and Piedmont 1945 – 1973 (PhD Thesis London School of Economics and Political Science 1997) 182

173 'The Origins of the Bank of Italy' Bank of Italy Representative Office for Japan, ARK Mori Bldg West-27F, 1-12-32, Akasaka, Minato-ku, Tokyo 107 Tel (03) 3588-8111

174 ibid

175 Ibid; The three banks which were merged were Banca Nazionale nel Regno d'Italia, Banca Nazionale Toscana, Banca Toscana di Credito per le Industrie e il Commercio d'Italia

of Italy became the country's only bank of issue.[176] As well as becoming the only bank of issue, the Bank of Italy was given powers of control over other banks and this was aimed at protecting savings.[177]

The period between the end of the nineteenth century and the beginning of the twentieth century saw very important banks such as the *Credito Italiano*, the *Banco di Roma*, the *Banca Commerciale Italiana* and the *Banca Nazionale del Lavoro* coming into existence.[178] In addition to major banks holding shares within the state governed iron and steel industries, three of these banks, the *Banca Commerciale Italiana*, the *Banco di Roma* and the *Credito Italiano*, also held shares in ailing Italian firms and had to be taken over by the government.[179] State control was intended to be permanent and shares taken from the affected banks were transferred to the *Istituto per la Ricostruzione Industriale (IRI)*.[180] In 1937, state ownership became permanent and as a result, the IRI having ownership over the three banks and their shares in the failed firms, became the largest state controlling holding company within the Westen economies.[181] The three major banks, the *Banca Commerciale Italiana*, the *Banco di Roma* and the *Credito Italiano*, became the *Banche di Interesse Nazionale*.

7.4.4 The 1936 Banking Law

The 1936 Banking Law established a structure which classified Italian banks into two main classes namely *Istituti di credito ordinario* (dealing only with savings deposit and short term operations) and *Istituti di credito speciale* (dealing with medium to long term operations). Among the *Istituti di credito ordinario*, six groups were identified depending on their property structure and bylaws namely: Public law banks (*Istituti di Diritto Pubblico*), banks of national interest (*Banche di Interesse Nazionale*), ordinary credit banks (*Banche di Credito Ordinario*), co-operative people's banks (*Banche Popolari*), savings banks (*Casse di Risparmio*) and rural and artisan banks (*Casse*

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176 ibid
177 ibid
178 F Carnevali, p 182; Some major bank collapses – those of the *Credito Mobiliare* and the *Banca Centrale* in 1893 and that of the *Banca di Sconto* in 1920 were the result of misguided use as venture capitalists and poor speculation by the Italian government. The crisis which followed the global economic slump in 1930 exposed the weaknesses within the Italian banking infrastructure; ibid.
179 Ibid pp 182,183
180 Ibid p 183
181 ibid

Rurali e Artigiane).[182]

The Banking Law of 1926, revised and supplemented by that of 1936's rigid regulatory regime, stemmed from the creation of IRI, *Istituto per la Ricostruzione Industriale* and IMI, *Istituto per la Mobilizzazione Industriale*.[183] IMI's dealings concerned medium and long term finance and they placed bonds representing different industrial sectors on the market.[184] During the period when the 1936 Banking Law came into force, most European regulators had the opinion that restricting competition would maintain bank rates at a level which would favour bank profitability.[185] The Bank of Italy's functional evolution did not end in 1936; whilst its institutional framework has not really changed, it has evolved as the custodian of a stable currency and economy and regulator of the country's financial sector development.[186]

In 1946, the Banking Law was updated with the Bank of Italy intending to reflect the pre war economists' view that the role of banks was to promote economic development.[187] The association between Italy's economic growth and the role played by banks was assessed by Raffaele Mattioli, chairman of the *Banca Commerciale Italiana*, who remarked that banks contributed to Italy's rapid economic growth in the 1950s and that this was as a result of the financial assistance given to mainly small firms.[188] The existence of small banks was also considered important since they provided assistance to small and medium- sized firms who would have been overlooked by larger banks.[189] Controls were in place to help preserve a system whereby small banks existing at regional or local levels could operate alongside the larger banks and as a result, bank competition was restricted to prevent a rise in industrial concentration.[190]

The direction taken by the body whose duty was to create post-fascist Italian institutions the

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182 F Carnevali, British and Italian Banks and Small Firms : A Study of the Midlands and Piedmont 1945 – 1973 (PhD Thesis London School of Economics and Political Science 1997) 184

183 ibid p 185

184 ibid

185 G Trequattrini, 'The Role of the Bank of Italy as Antitrust Authority in the Banking Sector' Banca d'Italia

186 The Origins of the Bank of Italy' Bank of Italy Representative Office for Japan

187 F Carnevali p 186

188 Ibid pp 186,187

189 Ibid p 187

190 Ibid; The Italian financial system has been described as one with a poorly developed capital market, under developed stock exchange and one which is bank oriented ;ibid p 199. Even though the current Italian banking system has been shaped through the 1926 and 1936 Banking Acts, the Italian financial structure, post 1945, developed as a result of the debate raised instigated by the Ministerial Committee of Inquiry on Finance and Insurance; ibid p 202.The debate involved amongst other things, the distinction between short- term loans, medium and long-term ones and also the differences between equity and debt finance.

Assemblea Costitutente, along with the recommendations of the Committee of Inquiry influenced the structure of Italy's financial system.[191] One very important finding of the Committee through interviews conducted with representatives of the country's various financial institutions was that even though the distinction between banks and provision of medium and long term finance was to continue, the stock market was not regarded as an important optional source of capital.[192]

Instead, it was considered that funds held by investors should be passed on to firms, that these would lend to firms and that they would also finance firms activities through the sale to public of industrial bonds.[193] From this, a financial system whereby funds were directed through institutions was seen as easier to direct than a system left in the control of individual firms and investors.[194] As a result, little was done to promote the development of the stock market.[195] Guido Carli, who succeeded Menichella as the Governor of the Bank of Italy in 1960, realised the need to develop the stock market in order to prevent firms suffering the consequences of imbalance between debt and equity.[196] The Bank of Italy also paid increased focus on the implications of its supervisory action for competition. Whilst priority was given to the objective of stability of the banking system in the fifties and sixties, during the 1970s, the objective of stability was coupled with that of higher efficiency which was to be achieved through promoting competition.[197]

7.4.5 The Efficiency/Inefficiency of the Italian Banking System

As stated earlier, the Banking Law of 1936 promoted a tightly regulated system which ensured that competition would not eliminate the smaller and more local banks. However as the country industrialised, the segmentation of the banking system and apparent absence of other financial systems (as the banking sector's prominence was evident), resulted in the efficiency of the Italian banking system being questioned – particularly from the mid 1970s onwards.[198]

Even though the contribution made by small banks (namely providing small and medium sized firms with capital) has been recognised, their place in a modern international, financial environment

191 Ibid p 202
192 Ibid p 203
193 Ibid p 203
194 Ibid p 204
195 Ibid p 204
196 Ibid p 205
197 G Trequattrini, 'The Role of the Bank of Italy as Antitrust Authority in the Banking Sector' Banca d'Italia
198 F Carnevali p 211

was contentious.[199] Small banks were considered inefficient because of their inability to achieve economies of scale, provide modern services and use advanced technologies.[200] The stifling of competition and rigid regulatory framework were other factors highlighted within the Italian banking system.

The system of Italian banking regulation before the nineties was therefore characterised by a structure that was highly fragmented, a system whereby specialisation was the dominant characteristic of the banking system and one whereby the greater part of banking business was carried out by public sector banks.[201] Strong structural controls, barriers to entry and restraints on assets and liabilities were also main features of bank regulation.[202]

7.4.6 Changes in the Italian banking industry and legal framework

Between 1990 and 1992, several Parliamentary Acts consolidated the Amato Law, resulting in a complete change of the legal framework for banking.[203] The Amato Law (218/1990) formed the basis of the legal framework and paved way for the privatisation of the Italian public banking system.[204] In 1993, the Legislative Decree 385 of 1st Sept 1993 (the 1993 Banking Law), replaced the 1936 Banking Law and consolidated all previous legislation in the banking industry. Under the 1993 Banking Law, previous distinctions between deposit banks and long-term specialised credit institutions were abolished and a model asymmetric to universal banking established. This was the start of a new era of consolidated supervision in which banking groups were formally recognised and non-bank financial intermediaries were incorporated in the regulatory framework.

Article 2 (title 1) of the 1993 Banking Law deals with **credit authorities** and section 1 assigns the highest supervisory authority for credit and the protection of savings to the Inter-ministerial Committee for Credit and Savings. The Inter-ministerial Committee for Credit and Savings decides on matters assigned to it by the Legislative Decree 385 and is composed of the Minister of the Treasury (its chairman) and seven other ministers from other government sectors. The Governor of the Bank of Italy has to attend these meetings and the meeting may also be attended (on invitation by the Chairman), by other ministers.

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199 Ibid p 211
200 Ibid p 212
201 G Trequattrini Banca d'Italia
202 ibid
203 F Carnevali p 184
204 See Deutsche Bank, 'Italy's Savings Banks: First Reforms Create Big Universal Banks with Untapped Potential' EU Monitor Financial Market Special Deutsche Bank Research November 25 2004 No 17

Article 4 of the 1993 Banking Law states the duties assigned to the Bank of Italy during the course of performing its supervisory functions. These duties include: the formulation of proposals for resolutions within the scope of the authority of the Credit Committee, the issue of regulations in cases provided for by law, issue of instructions and adoption of specific measures within the scope of its authority. It is also required to establish and give prior public notice of principles and methods relating to its supervisory activity, to establish time limits for the adoption of measures and publish an annual report on its supervisory activity. Article 5 (1) states the objectives and scope of financial supervision and this includes: the sound and prudent management of those subject to supervision, the overall stability, efficiency and competitiveness of the financial system.

Title 3, chapter 1 of the 1993 Banking Law deals with supervision of banks. Its provisions include reporting requirements,[205] notification by boards of auditors and persons appointed to audit the accounts,[206] regulatory powers of the Bank of Italy,[207] and inspections[208]. Title 3, chapter 2 deals with supervision on a consolidated basis and contains provisions relating to reporting requirements, regulatory powers of the Bank of Italy and inspections in Articles 66, 67 and 68 respectively.

Per capita GDP in Southern Italy is about 30% lower than national average with unemployment rate being around 18% - compared with 6% in the central parts and 3.8% in the north.[209] By the early 1990s, the South was a dependent economy structurally, with 36% of Italy's population.[210] During the recession of 1992-93, the reduction of domestic demand and interest rate adjustments required to face the crisis affected the profitability of firms. As a result of difficulties experienced by the southern banking system, supervisory action was required from the Bank of Italy and this was aimed at fundamental aims of protecting depositors and maintaining financial support for businesses in the south.[211] Between 1990 and 1995, on site controls were undertaken in the southern banking system and around 60% negative evaluation received – in contrast to 15% received by banks in the central and northern parts of Italy. The process of rehabilitating southern

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205 Article 51
206 Article 52
207 Article 53
208 Article 54
209 See Carosio, 'Italy, Europe and Financial Regulation'
210 A Goglio, 'Sectoral Regulatory Reforms in Italy : Framework and Implications'
211 A Fazio, 'The Reorganisation of the Italian Bank System' (Joint Session of the Sixth Committees of the Italian Senate and Chamber of Deputies 10 October 2002)

banks was aided through the Interbank Deposit Protection Fund and contribution from banking groups. One of such banking groups included *Banco di Napoli*. As the leading bank in South Italy, it had acted to support the southern banks and had been slow in adapting back – particularly in the face of an increasing competitive market.

The need to prevent a serious impact on the South's economy, avoid systemic risks required special legislation to be approved for the rescue of *Banco di Napoli*. As a result, Law 588 of 19 November 1996 was enacted and it provided for the Treasury to supply funds for recapitalisation. This was a unique occurrence as it was the first time public intervention had been made to adopt a restructuring plan which was approved by the Bank of Italy. *Banco di Napol*i's structures were renewed and factors which resulted in its crisis (factors such as bank loan portfolio, high costs and low efficiency of its operations) were corrected to align it with national average requirements. In addition to these developments within the legal framework, the 1998 Consolidated Law on Financial Intermediation has also enabled intermediaries to offer a wide range of asset management products.

7.4.7 The Central Bank's Role in Financial Regulation and Supervision: Post Parmalat Reforms

The post Parmalat reforms do not consolidate Italy's five financial regulators into one, unlike Britain's FSA and Germany's *BaFin.*[212] The post Parmalat reforms according to many, have been disappointing as the central bank, Bank of Italy had still managed to retain many of its powers whilst CONSOB has not been afforded as much power as was previously expected. According to the draft law of February 2004, a new regulator, provisionally called the Authority for the Protection of Savings was to replace CONSOB, the securities market watch dog.[213] This new CONSOB is to be more powerful than its predecessor and would take over the supervision of debt issuance from the Bank of Italy.[214]

The Italian financial regulatory framework went through a major overhaul in 2005 through the Law 262 of December 12th 2005 on Protection of Savings and Financial Markets Discipline.[215] This overhaul was triggered by the financial scandals relating to Cirio and Parmalat, two major Italian food companies.[216] The new legislation came into effect on the 10th January 2006 – however, due

212 See 'Italian Financial Regulation: Not So Super Consob' *The Economist* (Feb 5th 2004)
213 ibid
214 ibid
215 'Banks: Bank Regulators' Economist Intelligence Unit – Country Finance (Volume 7 No 2) 23 August 2006
216 ibid

to some provisions requiring secondary legislation, these provisions were not implemented straightaway. The legislation affects the Bank of Italy, CONSOB, the Competition Authority (*Autorita Garante della Concorrenza e del Mercato*), the Pension Fund Supervisory Committee (*Commissione Vigilanza Fondi Previdenza*) Covip, and the Institute for Supervision of Private and Collective Interest Insurance (*Istituto per la Vigilanza sulle Assicurazioni Private e di Interesse Collettivo*) Isvap.

A major impact of the new legislation on the Bank of Italy will be to increase the transparency of its operations and to transfer powers it holds in deciding upon the concentration (as opposed to the prudential implications) of mergers and acquisitions. These powers will be assigned to the Guarantee Authority for Competition and Markets (*Autorita Garante della Concorrenza e del Mercato*). Large crossborder bank mergers come under the jurisdiction of the European Commission. Transparency should be improved as a result of the following measures namely: Through requirements that board decisions having implications outside the central bank be taken by consensus, that written records be kept of board meetings and that the Bank of Italy report semi-annually on its activities to both the parliament and the government. The Bank of Italy and CONSOB will share strengthened powers over conflicts of interest.

Law 262 of December 12th 2005, resulted in distinct changes apart from those in the area of competition. Those that affect the Bank of Italy mainly involve requirements for greater transparency in its decision-making and more formal co-operation with insurance and financial-market regulators. New rules on avoiding conflicts of interest in financial-market operations will be the joint responsibility of the Bank of Italy and CONSOB. Bank of Italy rules on banks' exposure to associated groups acquired direct force of law, and the Bank of Italy has acquired the ability to impose administrative fines. A new system of arbitration of consumer disputes with banks is to be set up under Bank of Italy auspices to be funded by a levy on all banks. This had not yet been set up as of July 2006.

Both *Banca d'Italia*, Italy's central bank and the National Financial Markets Commission (*Commissione Nazionale per le Societa e la Borsa*, CONSOB) had been criticised for their inability to foresee the impending scandals.[217] There have been a lot of suggestions that the Bank of Italy has been entrusted with too much power and that CONSOB's powers need to be enforced and

217 ibid

increased.[218] This resulted to suggestions for reforms which would leave the basic form of supervision in its original form but replace CONSOB with a Financial Markets Authority which had more powers.[219] Even though it was later decided in the course of Parliament, not to replace CONSOB,[220] CONSOB now has more investigative powers and more personnel. Powers which relate particularly to issuance of financial instruments and companies established where company law is not transparent have been increased.[221]

Lack of close cooperative relationship between *Banca d'Italia* (Bank of Italy) and CONSOB was one of the reasons attributed to the Parmalat scandal. During the early months of 2002, financial analysts had voiced concerns about Parmalat's management's unwillingness to provide explanations of its financing strategy. [222] Apart from the failure of CONSOB to investigate Parmalat before it was apparent that market forces were discounting Parmalat's stock in reaction to its practices,[223] the Bank of Italy was criticised for failing to share with Consob vital information on distressed and defaulted debt apparent in the central bank records.[224]

The Italian public opinion favoured an Italian "Sarbanes Oxley" and even though work commenced rapidly on the reforms, Parliamentary work was delayed as a result of several factors which included the resignation of Italy's finance minister, Giulio Tremonti, who had campaigned tirelessly to reduce the central bank's powers.[225] In April 2005, Parliament through approval of the *Legge Comunitaria 2004* permitted implementation of the EU Market Abuse Directive 2003/6/CE.[226] These rules aimed at safeguarding transparency and fairness on financial markets came into force

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[218] See 'Italian Financial Regulation: Not So Super Consob' *The Economist* Feb 5th 2004; See also S Delaney 'Parmalat Spurs Call for Reform in Business: Italian Government Plans To Strengthen Oversight' *The Washington Post* (January 20 2004) <http://www.washingtonpost.com>

[219] 'Banks: Bank Regulators' Economist Intelligence Unit – Country Finance (Volume 7 No 2) 23 August 2006

[220] ibid

[221] Ibid; This latter measure is aimed at ensuring that another Parmalat-type abuse of corporate governance through the use of companise based in offshore tax havens is avoided.

[222] M Tonello, 'Have Governance Reforms Spurred on by Parmalat's Collapse Given Investors a False Sense of Security?' Novemeber 14 2006

[223] These practices involved the need to raise capital through complicated and expensive bond placements rather than using the "so-called" large amounts of cash falsely reported on its balance sheet; for more information on this see M Tonello, 'Have Governance Reforms Spurred on by Parmalat's Collapse Given Investors a False Sense of Security?' Novemeber 14 2006

[224] ibid

[225] See M Moriconi, ' Italy: Changes to the Legislative and Regulatory Framework post-Parmalat – Some Faster than Others!' Hill and Knowlton's Financial Services Newsletter Number 5 May 2005 ; 'Italian Financial Regulation : Not So Super Consob' *The Economist* Feb 5th 2004;

[226] See M Moriconi,' Italy: Changes to the Legislative and Regulatory Framework post-Parmalat – Some Faster than Others!' Hill and Knowlton's Financial Services Newsletter Number 5 May 2005

on 12 May 2005.[227] The Italian financial regulatory framework went through a major overhaul in 2005 through the Law 262 of December 12th 2005 on Protection of Savings and Financial Markets Discipline. CONSOB's powers have been re-inforced in many ways including:[228] Additional investigative powers; the capacity to directly apply sanctions; a new internal framework comprising 150 new officers and a new framework for collaboration with the "*Guardia di Finanzia*" (financial police) in order to carry out their surveillance activities. National implementation of the EU Market Abuse Directive has therefore strengthened CONSOB's powers. The Market Abuse Directive not only permits greater sanctions for abuse of privileged information and stock manipulation but also introduces new regulations on confidential communications, public communications and international cooperation between financial authorities.[229]

However, the reform on savings has been put on hold by the Senate.[230] However, reforms are not just sufficient on their own – better enforcement procedures need to be put in place. There is also need for better protection of smaller investors.[231] Where possible, many investors decided to sue Parmalat's lending banks and external auditors in US courts – US courts being perceived as having more expertise in corporate financial issues, providing more certainty of outcome and being more likely to provide more recovery of damages.[232] These are litigation facilities which are not available under Italian or many other European jurisdictions.[233]

According to the president of the Association of Italian banks, Maurizio Sella,[234] Italy would benefit from adopting an Act similar to that of Sarbanes Oxley. The need for external auditors to be more independent was also highlighted. As part of the post Parmalat reforms, Giulio Tremonti called for clearer demarcation between company and external auditors.[235]

Differences between the US and Italian systems would still need to be taken into account when considering whether or not to adopt certain Sarbanes Oxley measures. Differences between Italy

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227 ibid

228 See M Moriconi, ' Italy: Changes to the Legislative and Regulatory Framework post-Parmalat – Some Faster than Others!' Hill and Knowlton's Financial Services Newsletter Number 5 May 2005

229 ibid

230 ibid

231 M Tonello, 'Have Governance Reforms Spurred on by Parmalat's Collapse Given Investors a False Sense of Security?' Novemeber 14 2006

232 ibid

233 ibid

234 S Delaney, 'Parmalat Spurs Call for Reform in Business: Italian Government Plans To Strengthen Oversight' *The Washington Post* January 20 2004 <http://www.washingtonpost.com>

235 ibid

and the US include the fact that no established procedures in civil law exist to help investors who lose money in such cases to regain their losses; there are also no class-action lawsuits in Italy, contingency fees to lawyers helping in case of investors who cannot afford lawyers are illegal, no common rules about what businesses are required to write in prospectuses or what recourse investors have if a prospectus turns out to be false exist.[236]

7.4.8 Responsibilities of the Bank of Italy

Supervision of banking and asset management sectors: The Bank of Italy's approval is required in order to start up or acquire a bank or securities trading company. Its approval is also required to increase holdings above pre-determined thresholds in either banks or asset managers. The Inter-ministerial Credit and Savings Committee (Imitators Ministerially per ail Creditor e ail Disparage) CICR, formulates banking and credit policies. It cannot intervene in the decisions of the Bank of Italy. The purpose of the committee is to advise on new legislation and interpret existing legislation. It comes under the Ministry of Economy and Finance (Minister dell Economic e dell Finance). Its powers to issue secondary legislation have passed to the Bank of Italy and Con sob under the new law on savings and financial markets discipline.

Issue of coins: Having been a member of the European System of Central Banks (that is, the central banks of the European Union) and the Euro system (that is, the central banks of the Euro area) since June 1est 1998, coin issuance remains a national responsibility of the Bank of Italy even though the European Central Bank (ECB) is the issuing authority. Coin issuance by the Bank of Italy is however subject to ECB approval, since it affects the EMU's money supply. The Bank of Italy collaborates with the ECB on banking supervision as well as authorisation and the payments system. It also works with the Committee of European Banking Supervisors, set up in late 2003, which has its secretariat in London.

The Bank of Italy also operates the Centre for Financial Risks (Centrale dei Rischi), which keeps credit records on all national companies and business individuals. All credit operations, including factoring and leasing operations, and guarantees capitalised in excess of 75,000 are registered with this office. Credit institutions can check a loan applicant's overall exposure with the centre and also information which is available to credit institutions in other EU states.

236 ibid

The Italian Foreign Exchange Office ("*Ufficio Italiano dei Cambi*" UIC) is an arm of the Bank of Italy but it enjoys considerable independence. Primary functions include gathering balance-of-payments statistics and monitoring payment transactions for fraud and money-laundering. It is active in international financial markets on behalf of the public sector, as it hedges debt and invests in foreign paper, mainly sovereign issues. These form part of Italy's reserves. The UIC's role has diminished in recent years as part of Italy's reserves have been transferred to the European Central Bank (ECB), and many transactions that were previously in foreign currency are now in euros. The UIC monitors implementation of legislation on money-laundering, usury and transactions in gold, and keeps the register of non-bank financial intermediaries.

The Bank of Italy is also responsible for capital-adequacy oversight in the finance sector. The rules are incorporated in the Instructions for Banking Supervision (*Istruzioni di Vigilanza per le Banche*), which are updated regularly and of which the Bank of Italy issues a consolidated version at each update. They are based on EU Directives and the international Basle agreements on capital adequacy.

7.4.9 The Competition Authority

Powers relating to full responsibility for anti-competitive behaviour in the banking sector were granted to the Competition Authority on January 1st 2006. Previously, it had shared responsibilities with the Bank of Italy, and in some cases the latter had taken the lead. In January 2006, the Authority opened an investigation into retail banking service prices. In July 2006, it announced a 2.5% of turnover fine on CO.GE.BAN (*Convenzione per la Gestione del marchio Bancomat*), an agreement between banks on the terms and conditions for transactions via point-of-sale terminals connected to banks. The fine was for failure to comply with a Bank of Italy decision in October 2005 that maximum commission levels and restrictions on the ability to transact through the terminals of more than one bank were anti-competitive. The case was one that the Competition Authority had taken from the Bank of Italy under its new powers.

7.4.10 CONSOB

For listed financial institutions, takeover laws apply and the authority responsible for such cases is the stock-exchange regulator, CONSOB. CONSOB must be notified as soon as a company holds a stake of 2% in a listed company. The stake is calculated on the basis of voting rights. CONSOB must also be notified when stakes reach 5%, 7.5%, 10% and increments of five thereafter. Anyone participating in a voting pact that has a stake of more than 5% in total must notify CONSOB. The Bank of Italy's approval must be obtained for any investment of 5% or more in an Italian bank (or securities house (SIM), asset management company, financial company, including a consumer credit, leasing or factoring group), or in any company holding a stake of more than 5% in a bank, and of any subsequent increase to 10%, 15%, 20%, 33% and 50%. The 5% ceiling is calculated on the basis of voting rights but is not absolute. The criterion is the degree of control a company holds. If a company has control even over certain types of decisions, then it may require approval from the Bank of Italy. A stake of 10%, even without voting rights, is also subject to authorisation. A takeover bid is compulsory once the 30% threshold is reached in a listed company under Legislative Decree 58/98. New takeover legislation is likely to take effect in late 2006 when Italy implements EU Directive 2004/25 on takeovers.

7.5 Banking Regulation and Supervision in the United States

7.5.1 Financial Regulation in the US

7.5.1.1 Regulatory Structure in the US

Financial regulation in the US is quite fragmented and is carried out by the following institutions: For securities, the US Securities and Exchange Commission (SEC); For futures, the Commodity Futures Trading Commission;For securities SROs (Self-Regulating Organisations), the New York Stock Exchange, the American Stock Exchange Incorporation, the National Association of Securities Dealers, the Municipal Securities Rule-making Board ;For futures SROs (Self-Regulating Organisations), the National Futures Association.

Banking regulation is carried out by the Board of Governors of the Federal Reserve Board (FRB), the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC) and the Office of Thrift Supervision (OTS), the National Credit Union Administration and the Federal Financial Institutions Examination Council. Insurance regulation and supervision is almost entirely regulated at state level. This dates back to when the first major insurance scandal occurred in New York in the early 1900s. As a result of this, New York imposed a law prohibiting the insurance services sector from engaging in banking and securities activities. Other states decided to follow this lead and the situation remains the same till today.

7.5.2 History of US Financial Regulation

Until 1863, US banks were regulated at state level. In that same year, a need arose for a means whereby the Federal Government could raise some source of funding. The Civil War had been going on for two years and the Federal Government was in need of cash. The National Banking Act came into existence two years later – with the formation of the OCC. A dual system of banking was introduced whereby some banks were chartered and regulated by the states and some banks were chartered and regulated by the OCC.

The 1913 Federal Reserve Act led to the formation of the Federal Reserve System as a central bank and lender of last resort. Prior to 1933, US securities markets were regulated to a large extent. However events such as the 1929 US stock market crash and a "run" on the banks by depositors (who feared that banks would be unable to repay the money in their accounts) led to the enactment of two important pieces of legislature namely the Securities Act of 1933 and the Securities Exchange Act of 1934. Many banks had collapsed as a result of the stock market crash and as a result, the 1933 Banking Act was enacted. The 1933 Banking Act (also known as the Glass Steagall Act), distinguished between commercial and investment banks and led to the creation of the Federal Deposit Insurance Corporation which was to provide deposit insurance to commercial banks. The 1934 Securities Exchange Act provided the framework for a partnership between the legislature and the judiciary which aimed to achieve the tasks of imposing minimum standards of information disclosed by companies who issue publicly-listed shares or bonds, controlling the quality of that information and policing the market place[237]. The Act also led to the establishment of the Securities and Exchange Commission (SEC) as the primary regulator for US securities markets.

The distinction made by the Glass Steagall Act of 1933, between commercial and investment banks had been getting blurred over the years – due to global developments which had not been foreseen when the 1933 Act was enacted. The original 1933 Act allowed banks to deal in exempt securities and over the years, authorisation was expanded to allow banks to deal with non-exempt securities (through their subsidiaries). Under the Glass Steagall Act, commercial banks could also participate

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[237] N Veron, 'Strengthening Europe's Capital Markets' see < http://www.ecif.info/CapitalMark> (last visited 15 Dec 2005)

in overseas securities business. Shortcomings of the Glass Steagall Act included failure to incorporate derivatives such as OTC derivatives markets, such derivatives not having been foreseen when the Act was enacted in 1933. Also currencies were not classed as securities even though they entailed similar market risks. The legal definition of "securities" under the 1933 Act also did not incorporate futures markets. Due to these shortcomings, commercial banks were able to take significant risks and a new legislation had to be introduced. This led to the Financial Services Modernisation Act (also known as the Gramm-Leach-Bliley Act) being passed by Congress in 1999. The Act removed the distinction between commercial banks and securities business.

There was still a lot of debate and concern as to how OTC derivatives were to be regulated. The Commodities Futures Modernisation Act was passed by Congress in 2000, replacing the 1974 Commodity Exchange Act. OTC derivatives were to be left unregulated.

As a result of the collapse of Enron, Congress passed the Sarbanes Oxley Act (also known as SOX) in 2002. The Sarbanes Oxley Act is an Act which aims 'to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes.' On February 13th 2002, the SEC also called for changes to corporate-disclosure rules.[238] Businesses would now have to disclose transactions in company shares by executives rather than waiting up to 45 days.[239] Annual results now have to be posted within 60 days not 90 days and quarterly results published within 30 rather than 45 days.[240] Firms would also have to explain their reasons for certain accounting treatments.[241]

The US bank regulators are as follows: The Federal Reserve Board, the Federal Deposit Insurance Corporation (FDIC), the National Credit Union Administration, the Office of the Comptroller of the Currency (OCC) and the Office of Thrift Supervision (OTS).[242] The main focus of this research will be the Federal Reserve Board. Unlike federal regulators such as Britain's FSA, Germany's *BaFin* and the newly empowered Italian CONSOB, the US Federal Reserve Board is also the central bank and is therefore responsible for setting monetary policy. The Federal Reserve has regulatory and supervisory control over an extensive range of financial institutions and activities. Alongside other

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238 'Financial Regulation in America : Pitt the Gamekeeper" *The Economist* February 14th 2002 <http://www.economist.com/displaystory.cfm?story_id=988338>

239 ibid

240 ibid

241 ibid

242 See 'The Federal Reserve Board: Enforcement Actions' <http://www.federalreserve.gov/boarddocs/enforcement/>

federal and state supervisory authorities, it works to ensure the safety and soundness of financial institutions, stability within the financial markets and fair treatment of consumers in their business transactions.[243]

A dual system of banking exists and operates in the US. This dual system of banking refers to the parallel state and federal banking systems. The Federal Reserve Board regulates **state** member banks.[244] **State non member** banks are regulated by the FDIC. **National** banks, federally chartered branches are regulated by the OCC.

Foreign banks are regulated by the FDIC (insured branches of foreign banks)[245], foreign state licensed branches and agencies are regulated by the Federal Reserve and the FDIC whilst foreign federally licensed branches and agencies are regulated by the OCC and the FDIC.[246] Other regulators, namely the National Credit Union Administration and the Office of Thrift Supervision regulate credit unions and thrift associations respectively.[247]

7.5.3 Main Objective of the Supervisory Process

This is the evaluation of the overall safety and soundness of the banking system which includes assessing risk-management systems, financial condition of banks and whether banks are complying with relevant banking laws and regulations.[248]

7.5.4 Collaboration with Other Regulators

One of the main objectives of the Gramm-Leach-Bliley Act was to enable banks, securities broker-dealers and insurance companies associate with each other through the structure of the bank holding company.[249] In order to benefit from the extended associations allowed under the Gramm-Leach-Bliley Act, a bank holding company must meet certain capital, managerial and other conditions and must elect to become a "financial holding company".[250]

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243 *The Federal Reserve System, Purposes and Functions* (Board of Governors of the Federal Reserve System July 2005) 59

244 'The Federal Reserve Board: Enforcement Actions' <http://www.federalreserve.gov/boarddocs/enforcement/

245 ibid

246 *The Federal Reserve System, Purposes and Functions* p 61

247 'The Federal Reserve Board: Enforcement Actions' <http://www.federalreserve.gov/boarddocs/enforcement/

248 *The Federal Reserve System, Purposes and Functions* (Board of Governors of the Federal Reserve System July 2005) 62

249 Ibid p 65

250 ibid

7.5.5 Enforcement

Where it is concluded that a state member bank or bank holding company has problems which could affect the institution's viability and well-being or that it is not acting in compliance with laws and regulations, the Federal Reserve may resort to taking supervisory action to ensure that the institution amends its ways.[251] Usually management and directors of the banking organisation are informed of such findings in the form of a written report, asked to respond to all identified problems voluntarily and take necessary action to ensure that such problems do not recur.[252] In other cases however, the Federal Reserve may be compelled to take informal supervisory actions or formal enforcement actions to ensure that management and directors of an affected banking organisation or persons associated with it address the organisation's problems.[253]

7.5.6 The Federal Reserve Board

The Federal Reserve Board not only regulates state member banks, branches and agencies of foreign banking organisations operating in the US and their parent banks, but also bank holding companies, non bank subsidiaries of bank holding companies, edge and agreement corporations.[254] As well as performing dual functions of regulator and setting monetary policy, the Federal Reserve is also empowered with statutory authority to take formal enforcement actions against banks, companies and organisations it regulates.[255] It can also take formal enforcement actions against officers, directors, employees and certain other classes of individuals associated with the banks, companies and organisations it regulates.[256] These individuals are known as "institution-affiliated parties." Formal enforcement actions such as cease and desist orders, written agreements, removal and prohibition orders, orders assessing civil money penalties may be taken where those regulated act in violation of laws, rules, carry out unsafe practices, breach fiduciary duties and violate final orders.[257]

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251 Ibid p 66

252 ibid

253 Ibid; Informal supervisory actions include requiring an institution to adopt a board resolution or agreeing to provisions within a Memorandum of Understanding to correct the problem. Formal enforcement measures include the Federal Reserve entering into a written agreement with the affected institution, issuing a cease-and-desist order against the institution or individual associated with the institution (officer or director), assessing a fine, removing an officer or director from office and permanently prohibiting him or her from the banking industry, or both ; ibid

254 'The Federal Reserve Board: Enforcement Actions' <http://www.federalreserve.gov/boarddocs/enforcement/

255 ibid

256 ibid

257 ibid

7.5.7 Historical Background

The Federal Reserve was established by Congress in 1913 and given the power to coin money and regulate its value.[258] This responsibility had originally been granted to the Congress by the US Constitution.[259]The Federal Reserve Act of 1913 empowered the Federal Reserve in giving it responsibility for setting monetary policy.[260] The mission of the Federal Reserve Board as set out by the Congress is as follows:[261] To maintain price stability; to foster maximum sustainable growth in output and employment and to facilitate a stable and efficient financial system.

7.5.8 The Supervisory Process

The supervisory process consists of both on-site examinations and inspections and off-site surveillance and monitoring. State member banks must usually have an on-site examination at least once every twelve months whilst banks with assets of less than $250 million which meet certain management, capital and other criteria are likely to be examined once every 18 months.[262] According to the Basel Core Principles for effective Banking Supervision 1997, an effective banking supervisory system should consist of a mix of both "on-site" and "off-site" supervision.[263] Off-site supervision involves the regulator making use of external auditors. On-site work is usually done by the examination staff of the bank supervisory agency or commissioned by supervisors but may be undertaken by external auditors.

In the US, periodic on-site examinations are carried out and justified on the basis of the large number of small banks and on unit banking within particular states.[264] Unlike jurisdictions where authorities place reliance on outside experts, bank supervisors in the US must possess skills in order to evaluate asset quality and other areas governing a bank's activities.[265] The disadvantage in this is that it can be labour intensive and restricted by budgetary constraints.[266] US supervisory authorities have responded to resource constraints in recent years by making greater use of off-site surveillance

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258 See Remarks by Chairman Ben S Bernanke at the Ceremonial Swearing In by President Bush, Federal Reserve Board of Governors, Washington D.C, Feb 6 2006 ; <http://www.federalreserve.gov>

259 ibid

260 See 'Monetary Policymaking : Federal Open Market Committee' ; <http://www.federalreserve.gov/fomc/

261 See Remarks by Chairman Ben S Bernanke at the Ceremonial Swearing In by President Bush, Federal Reserve Board of Governors, Washington D.C, Feb 6 2006 ; <http://www.federalreserve.gov>

262 *The Federal Reserve System Purposes and Functions* p 62

263 See The Relationship between Bank Supervisors and External Auditors", Basel Committee Publications No. 87 January 2002. Also see Basel Core Principles for Effective Banking Supervision 1997, Basel Committee Publications No. 30 (September 1997);< http://www.bis.org/publ/bcbs30a.htm>

264 V Polizatto, 'Prudential Regulation and Banking Supervision: Building an Institutional Framework for Banks' (January 1990) World Bank Working Paper at p 17

265 ibid

266 ibid

systems.[267] However the use of off-site surveillance systems can also be disadvantageous as computers cannot observe certain aspects of examinations namely the scrutiny of management practices.[268] For this reason, the use of external auditors is also encouraged.

Results from US on-site examinations or inspections are communicated to the board of directors and management of the bank or holding company.[269] The confidential rating, based on a supervisory rating system is a supervisory tool used by all of the federal and state banking agencies to communicate assessments to bank organisations.[270] It is also used to identify potentially problematic institutions which require special attention.[271] The Federal Reserve also performs on-site examinations to ensure banks' compliance with consumer protection laws, compliance with fiduciary activities, transfer agency, securities clearing agency, government and municipal securities dealing, securities credit lending and information technology.

7.5.9 Off-site Monitoring

The Federal Reserve utilises automated screening systems to detect organisations with poor or deteriorating financial profiles in order to make predictions on adverse trends which may be imminent in the banking industry.[272]

The system of bank supervision in jurisdictions such as Germany is based on one which delegates on-site examination and inspection of banks and the verification of their records to external auditors.[273] In Germany, general auditors perform bank examinations and must inform the authorities should they discover facts warranting an audit qualification.[274] In comparison to this, the UK's system involves a reduced use of external auditors and mixed system of supervision whereby its regulator, the Financial Services Authority inspects banks (on-site) and utilises external auditors (off-site).

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267 ibid

268 See 'Off-site Surveillance Systems' < http://www.fdic.gov/bank/historical/history/vol2/panel2.pdf> last visited 17 November 2006. Also see advantages and disadvantages of Off site Monitoring on pp 479,480

269 *The Federal Reserve System Purposes and Functions* p 63

270 ibid

271 Ibid; The rating system for banks is usually abbreviated to CAMELS meaning: Capital adequacy, Asset quality, Management and administration, Earnings, Liquidity and Sensitivity to market risk.

272 Ibid p 64

273 V Polizatto, 'Prudential Regulation and Banking Supervision : Building an Institutional Framework for Banks' (January 1990) World Bank Working Paper p 15

274 ibid

7.5.10 Structure of the Federal Reserve System

The Federal Reserve System is made up of the Board of Governors, the Federal Open Market Committee, reserve banks and the Board of Directors.[275] The Federal Open Market Committee performs the vital role of making monetary policy decisions. The Federal Reserve utilises three tools of monetary policy namely: open market operations, the discount rate and reserve requirements.[276] Responsibility for the discount rate and reserve requirements lies with the Board of Governors of the Federal Reserve System whilst the Federal Open Market Committee controls open market operations.[277]

7.6 Second Investigative Aim: Risk Based Supervision and its Growing Importance

The main focus of jurisdictional comparison here will be between the UK and the US. The US places great importance on the Basel II Accord as it realises the importance of adopting a system which can efficiently manage risks in the face of increasing conglomeration and globalisation. Due to historical factors and the complex structure of financial regulation which currently exists in the US, a move towards the adoption of a single regulator would call for considerable change. Although the US realises the importance of having a single regulator which can manage more efficiently cross sector services' risks, implementation would be a daunting task for which it is not yet prepared. In the light of this, there is great interest in implementing the Basel Capital II Accord.

Financial markets all over the world have witnessed considerable changes as more complex methods of dealing with assets, liabilities and improved risk management techniques have been developed to enhance the profitability of financial intermediaries.[278] The combination of deregulation and developments in risk management techniques has meant that regulators can no longer focus on traditional risks linked to the business they authorised and the need to acquire an understanding of other forms of risks has been realised.[279]

Risk based supervision incorporates not only internal risks inherent within the regulated institutions, but also external risks. In this respect, it differs from meta regulation (of which the Basel II Capital

275 <http://www.federalreserve.gov/pubs/frseries/frseri2.htm>
276 See <http://www.federalreserve.gov/FOMC/> (last visited 22nd February 2006)
277 ibid
278 D Singh, 'Legal Aspects of Prudential Supervision' [2007] 85
279 ibid p 86

Accord is an example) which draws firms into regulatory processes and attempts to both influence and make use of firms internal risk management and control strategies.[280] Since external risks are more subjective and not as easy to measure, it could be argued that meta regulation presents a more accurate means of measuring risks. The difficulties in measuring such external related risks has been acknowledged in Basel II through the establishment, by the Basel Committee on Banking Supervision, of a specific treatment for operational risk[281]. It is evident however that firms do indeed face external risks so it can also be said that risk based supervision by focussing more on external risks quantitatively, adopts a more realistic approach to external risks. Whichever way the argument goes, the underlying issue remains the same – both forms of regulation focus on risks. Whilst one form of regulation may seem more advantageous than the other, both still have inherent disadvantages.[282]

To a large extent, risk based regulation does not rely on past performance indicators.[283] The importance of future performance indicators has become increasingly evident in today's world. Whilst it has been argued that risk based supervision ultimately relies on past performance,[284] the availability of experienced staff who can identify inconsistencies in the information provided to them will better facilitate the use of the risk based approach.

The risk based approach structures regulatory decision-making in a more coherent way and also highlights the complex nature of decision making and the judgement required to be exercised.[285]

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280 J Gray and J Hamilton, *Implementing Financial Regulation: Theory and Practice* (2006) 36; Operational risks however also incorporate risks resulting from external events

281 The new framework of Pillar 1 of Basel II establishes that capital calculation be founded on a combination of qualitative and quantitative elements including internal data, relevant external data, scenario analysis and bank specific business environment and internal control factors. See M Moscadelli, 'The Modelling of Operational Risk : Experience with the Analysis of Data collected by the Basel Committee' *Banca D'Italia Temi di Discussione del Servizio Studi* Bank of Italy, Banking Supervision Department Number 517, July 2004.

282 One major advantage of meta-risk regulation is that it should enable the FSA exploit the expertise of the industry in an age when the complexity and volatility of modern risk calls into question the ability of financial regulators to stay one step ahead. A disadvantage lies with its use of mathematical models; ibid p 38. Other dangers with meta-risk regulation involve meta-risk management seeking to leverage off firms' own systems and expertise in aid of reducing risks to the FSA's objectives rather than directly imposing detailed requirements on firms as to the design of their internal risk assessment and management strategies.

In relation to risk based supervision, it has been argued that it may not be an accurate indicator of future performance; see D Singh, 'Legal Aspects of Prudential Supervision' 2007 p 95 Hence the importance of having experienced staff who are able to spot inconsistencies in the information provided. The risk based approach also presents concern in that regulatory resources are focussed mainly on areas that pose the greatest risk at the expense of those parts of the business considered to have lower risk; ibid p 132

283 Risk ratios enable the prediction, well in advance and before a bank collapses, of which banks are more likely to fail. See 'Off-site Surveillance Systems' < http://www.fdic.gov/bank/historical/history/vol2/panel2.pdf>

284 See D Singh, 'Legal Aspects of Prudential Supervision' [2007] 95

285 ibid

Timely, accurate and complete information is particularly important to regulators – especially in situations where the central bank is not really involved in supervision.[286]

The UK's financial regulator, the FSA, operates on a risk-based approach whereby it differentiates between regulated institutions and allocates resources to areas of greater perceived risk.[287] It identifies three sources of risk namely:[288] The external environment; consumer and industry-wide risks and the regulated institutions themselves.

7.6.1 Risk-Based Regulation and Supervision in Germany

The importance of risk-related information as a vital component of companies' annual reports when performing operating and financial reviews (OFRs) of listed companies was highlighted in a report aimed at inquiring into the arrangements for financial regulation of public limited companies in the UK.[289] This ensued from the realisation that traditional financial statements, no matter how well constructed, would not always provide sufficient information for analysts and investors.[290]

As part of the implementation of the Financial Conglomerates Directive, section 25 a (1) was amended in the last quarter of 2004.[291] The implementation of the European Financial Conglomerates Directive into German Law took effect on the 1st Jan 2005 and it requires clearly for a strategy whereby the institution's ability to manage risks as part of a proper business organisation is taken into account[292].

The adoption of a risk based approach to financial regulation and supervision in Germany has been

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286 The exchange of information between the FSA and the Bank of England occurs through the Memorandum of Understanding

287 See J Hitchins M Hogg and D Mallett, *Banking: A Regulatory Accounting and Auditing Guide* (The Institute of Chartered Accountants 2001) 120,121. In January 2000, the FSA announced its adoption of risk as a driver for its "business", see J Gray and J Hamilton, 'Implementing Financial Regulation' 2006 p 25. There are however questions surrounding the suitability of risk as a capable regulatory tool due to its contested nature.

288 Ibid p 121

289 See House of Commons - Treasury – Minutes of Evidence , House of Commons Environmental Audit, Fourth Report 13 March 2007 Session 2006/2007 <http://www.publications.parliament.uk/pa/cm200607/cmselect/cmenvaud/227/22702.htm> (last visited 22nd August 2007)

290 ibid

291 NO Angermueller, M Eichhorn and T Ramke, 'New Standards of Banking Supervision – A Look at the German Implementation Approach for the Second Pillar of Basel II' 2005 (2) Journal of International Banking Law and Regulation 52; Section 25 (a) deals with particular organisational duties of institutions

292 See also Deutsche Bundesbank, 'Supervision of Financial Conglomerates in Germany' Monthly Report (April 2005) 39

prompted by the significance of financial conglomerates.[293] Financial conglomerates have significant influence on financial stability particularly when they have a notable level of market share in several financial sectors and gain increasing significance in the market as a result of their size.[294] The objectives of the Financial Conglomerates Directive *interalia* includes ensuring the sound supervision of additional risks associated with financial groups who are involved in cross-sector financial activities.[295] It also encourages member states to develop their standards for limits on risk concentrations or permit their national supervisors to do so until there is further coordination.[296]

The implementation of the EU Financial Conglomerates Directive in Germany considers the growing economic importance of financial conglomerates and for the first time, supervisors now have a weapon in overcoming risks to the financial system attributed to financial conglomerates.[297] The *Bundesbank*'s significant involvement in financial conglomerates' reporting enhances its ability to assess risks to enterprises within a conglomerate and the risks to financial stability attributed to financial conglomerates.[298]

Despite the *Bundesbank*'s involvement, supervisors are still challenged by the fact that sectoral supervisory requirements address the relevant risks differently and that there is still no integrated approach to cross-sector supervision of equivalent risks.[299] Supervisors are therefore still largely confining themselves to a form of monitoring that informs them about risk concentrations and intra-group transactions but does not yet set integrated supervisory upper limits across all sectors - which appears reasonable[300].

It is therefore important, prior to creating more extensive supervisory standards, to compile information and gather experience based on incoming reports. Arrangements to resolve or at least disclose conflicts of interest resulting from business activity in different financial sectors have also

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293 Ibid p 44
294 Ibid pp 45,46
295 Ibid p 48
296 Ibid p 51,52
297 Ibid p 55
298 Ibid ; also see Deutsche Bundesbank, 'The Deutsche Bundesbank's Involvement in Banking Supervision' Monthly Report (September 2000)
299 See Deutsche Bundesbank, 'Supervision of Financial Conglomerates in Germany' Monthly Report (April 2005) p 55
300 ibid

not been reached.[301] The focus of the supervision of companies belonging to a financial conglomerate remains on individual supervision that is supplemented, but not overrided, by rules governing group-wide supervision (solo-plus approach).[302]

7.6.2 Has the Approach to Risk-based Regulation influenced the Degree of involvement of External Auditors in Germany?

The *Deutsche Bundesbank* and German Financial Supervisory Authority (BaFin): Statistics ongoing banking supervision[303]

Ongoing banking supervision operations, Number of operations conducted

Item	2002	2003	2004
¹ Revised from the previous year. Source: *Deutsche Bundesbank*			
Individual reports pursuant to sections 13 to 14 of the Banking Act	206 971	153 035	186 754
Single borrowers included in the summary reports submitted pursuant to sections 13 to 14 of the Banking Act	2 314 292	1 832 038	2 126 336
Reports pursuant to sections 24 and 24a of the Banking Act	47 585	44 561	47 002
Monthly returns pursuant to section 25 and 25a of the Banking Act	42 992	40 918	38 558
Reports on the volume of foreign lending (country risk) pursuant to section 25 (3) of the Banking Act	270	370	912
Auditors' reports on annual accounts	3 378	3 263	3 253

301 ibid
302 ibid
303 Source : <http://www.bundesbank.de/bankenaufsicht/bankenaufsicht_bafin_fenster.en.php>

Item	2002	2003	2004
Reports on the auditing of safe custody accounts	614	483	644
Routine, special and deposit guarantee fund auditors' reports	1 887	1 755	1 678
Audits pursuant to sections 44 and 44c of the Banking Act	69	79	155
Auditors' reports on the special funds of investment companies	1 431	1 309	1 459
Reports from investment companies on their activities	6 635	6 891	6 606
Reports under Principle I	32 846	29 923	28 907
Reports under Principle II	31 617	28 990	27 789
Audits of internal risk models	8	9	6
Reports under the Capital Accord of the Basel Committee on Banking Supervision	76	76	81

From the statistics on ongoing banking supervision, it can be seen that although auditors' reports on annual accounts, routine special and deposit guarantee fund auditors' reports have decreased, audits pursuant to sections 44 and 44c of the Banking Act, auditors' reports on the special funds of investment companies have increased. Particularly notable is the significant increase in sections 44 and 44c audits pursuant to the Banking Act. Between 2002 and 2004, these audits have more than doubled.

From this, it can be inferred that the adoption of risk based regulation in financial supervision in Germany has overall, not resulted to a reduction in its use of external auditors. The growing importance of risk-based regulation is also highlighted through risk-oriented reporting as it now represents a significant component of standard disclosure requirements and credit institutions must not only explain their assets and other elements but also outline their own risk situation and their ability to manage these risks.[304] The growing importance of using external auditors is also demonstrated through the Basel Committee's recommendations[305] and certain post Enron reforms.[306]

7.6.3 The Impact of Basel II on German Banking Supervision

It was expected that the new Basel Capital Accord would result to a shift as on-site prudential audits assume greater importance within the supervisory review process and came to supplement the evaluation of reports and returns from institutions.[307] This seems to be reflected in the above table of statistics on ongoing supervision. Basel II has three pillars namely: Minimum capital requirements, supervisory review process and market discipline. Even though the past years have concentrated on pillar 1, pillar 2 presents a great challenge for banks and supervisory agencies.[308] In October 1995, following the collapse of Barings Bank, which was attributed to inadequate control mechanisms, organisation and risk management, *BaFin's* predecessor, the *Bundesaufsichtsamt fuer das Kreditwesen* circulated the statement on “minimum requirements for the trading activities of credit institutions”.[309] *BaFin* gave an official statement regarding the implementation of Pillar 2 on the 15th April 2004.[310] The foundation for this is a new circular called MaRisk (minimum requirements for risk management).[311]

Pillars 1 and 3 are to be covered by the new solvency directive *Solvenzverordnung*. Section 10 (1b) of the German Banking Act will be amended with regards to pillar 2.[312] Pillar 2 not only seeks to ensure that banks have adequate capital to support all the risks related to their activities, but also encourages banks to develop and implement better risk management techniques in monitoring and

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304 See Deutsche Bundesbank, 'New Transparency Rules for Credit Institutions' Deutsche Bundesbank Monthly Report (October 2005) p 69

305 Basel Committee's Core Principles for Effective Banking Supervision and the Relationship between Banking Supervisors and Banks' External Auditors , International Auditing Practices Committee

306 See Deutsche Bundesbank, 'The Evolution of Accounting Standards for Credit Institutions, Deutsche Bundesbank Monthly Report (June 2002) p 39

307 Deutsche Bundesbank, Deutsche Bundesbank's Involvement in Banking Supervision Monthly Report (September 2000) p 37

308 NO Angermueller, M Eichhorn and T Ramke, 'New Standards of Banking Supervision – A Look at the German Implementation Approach for the Second Pillar of Basel II' (2005) 2 Journal of International Banking Law and Regulation 45

309 Ibid p 47

310 ibid

311 ibid

312 Ibid p 52

managing their risks.[313]

Basel II goes beyond the current German bank regulations – as a result there are not only inconsistencies, but also gaps between the regulations.[314] When comparing the minimum requirements for the credit business of credit institutions (MaK) with Basel II Internal Risk Based approaches, in detail, it is evident that requirements for IRB approaches are beyond those of the MaK.[315] As a result of its higher sophistication, those ratings which fulfil IRB requirements will also fulfill MaK requirements but the reverse is not the same.[316]

The minimum requirements for risk management (MaRisk) combines the minimum requirements for the credit business of credit institutions (MaK), MaH and MaIR.[317] As well as paving way for more holistic regulation, this merger should prevent further risk classes specified in the New Basel Capital Accord.[318]

7.7 Risk Based Approach to Bank Supervision in Italy

Supervisory activities aimed at increasing the capitalisation of banks – particularly major ones and to manage their risks of large exposures became more of a regular practice in 2001.[319] Methods for certifying banks' internal models for market risk calculation and related capital charges were also established.[320]

The Bank of Italy is taking measures to implement the new Basle Capital Accord.[321] In accordance with the EU's Capital Adequacy Directives 2006/48 and 2006/49 on the taking up and pursuit of the business of credit institutions and the capital adequacy of investment firms and credit institutions respectively, the so-called Basle II capital-adequacy principles will take effect as from January 1st 2007. The exception will be for financial institutions adopting more sophisticated methods of risk calculation, who will be allowed to adopt the principles on January 1st 2008. Although the EU will apply Basle rules to all banks and investment firms, and not just to those that are internationally

313 ibid p 55
314 ibid
315 ibid 52
316 ibid pp 52,52
317 ibid p 54
318 ibid p 55
319 See 'Supervision of Banks and Other Intermediaries: Banking Supervision", Bank of Italy at p 205 <http://www.bancaditalia.it/vigilanza_tutela/vig_ban/pubblicazioni/rela/2001/Supervision.pdf> last visited Jan 20 2007
320 ibid
321 Ibid

active as required by the Basle Accord, a number of adjustments have been made to incorporate EU specifications and to make life easier for smaller firms. There are areas where national discretion may be exercised. There will be lower capital requirements in the EU rules for banks venture-capital business in order not to put excessive dampers on finance for start-ups, given that these are regarded as crucial for the future growth and competitiveness of the EU. This directive will introduce a common regulatory approach to securitisation across the EU for the first time. The Bank of Italy was still consulting with Italian financial institutions as of end-July 2006 on details relating to the Italian legislation for the purposes of transposing EU directives into national legislation.

In the area of **credit risk,** low- and medium-risk investment firms will be able to continue using the existing expenditure-based rules for credit risk, though they will have to divide their exposures into a larger number of classes. This will be known as the standardised approach. The more sophisticated approach for other financial institutions uses t**he internal ratings-based (IRB) method** based on the Basel agreement, but will comprise foundation and advanced approaches. Less complex institutions will be able to mix the less and more sophisticated methodologies.

There will be similar **flexibility in addressing operational risk**, consisting of **three levels: the basic indicator approach, the standardised approach, and the advanced measurement approach (AMA)**[322]. These levels reflect the increasing levels of risk sensitivity. The standard definition of operational risk as agreed to by the Risk Management Group of the Basel Committee and industry representatives is "the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events."[323] This definition includes legal risk and excludes strategic and reputational risk and depends on the classification of operational risks according to the underlying causes[324]. Other important operational risk issues currently encountered by banks include business-continuity planning, the role of internal and external audits, the outsourcing of business functions and electronic banking.[325] Since 2001, the Basel Committee's Risk Management Group has been carrying out surveys of banks' operational loss data with the aim

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[322] The basic approach is founded on a fixed percentage of gross income, the standardised approach extends the basic approach by breaking down banks' activities into components' and the advanced measurement approach is based on the adoption of banks' internal models. See M Moscadelli, 'The Modelling of Operational Risk: Experience with the Analysis of Data collected by the Basel Committee' (July 2004) *Banca D'Italia Temi di Discussione del Servizio Studi* Bank of Italy, Banking Supervision Department Number 517/2004

[323] ibid p 10

[324] ibid

[325] D Quiroz Rendon, 'The Formal Regulatory Approach to Banking Regulation' Badell and Grau Legal Consultants ; also see <http://www.badellgrau.com/legalbanking.html> (last visited 10 June 2007)

of obtaining information on the sector's operational risk experience and also with a view to refining the capital framework.[326] The Bank of Italy checked the state of preparedness of Italy's eight largest banking groups in 2005 and concluded that management was well aware of the imminence of the changes and that statistical systems were adequate. However, it identified a need for improvements in the quality of data and in IT systems for modelling.

There will be a single consolidating supervisor through which cross border groups will channel applications to use the IRB and AMA methodologies. Decisions will be made within six months by the different supervisors acting together.

7.8 Risk Based Supervision in the US

The Federal Reserve also operates according to a risk-focussed method of supervision which was adopted not only as a result of the ever growing size and complexity of banks, but also because of the continuity inherent in its nature – as opposed to a point-in-time examination.[327] The risk based approach was also introduced following the 'savings and loans' debacle of the late 1980s and 1990s.[328] The risk-based supervision process aims to ascertain the greatest risks to a banking organisation and evaluate the ability of the organisation's management to identify, measure, monitor and control those risks.[329] Businesses which have the potential to produce the greatest risks form the main focus of examination carried out by Federal Reserve examiners.[330] The risk management component consists of four sub components which indicate the effectiveness of the banking organisation's risk management and controls namely: Board and senior management oversight; Policies, procedures and limits; Risk monitoring management information systems and Internal controls.[331] According to Alan Greenspan, a combination of improved risk management and the utilisation of financial derivatives to manage the risk portfolio has enabled banks to calculate risks more efficiently in business, which in turn has resulted to a reduction of the burden of the banking system on its regulators.[332]

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[326] See M Moscadelli, 'The Modelling of Operational Risk: Experience with the Analysis of Data collected by the Basel Committee' (July 2004) *Banca D'Italia Temi di Discussione del Servizio Studi* Bank of Italy, Banking Supervision Department Number 517/2004 p 10

[327] *The Federal Reserve System Purposes and Functions* p 63

[328] D Singh 'Legal Aspects of Prudential Supervision' 2007 p 127

[329] *The Federal Reserve System Purposes and Functions* p 63

[330] ibid

[331] ibid

[332] A Greenspan, 'Banking', *Federal Reserve Bulletin*, 7 October (2002)

The move towards a risk-based approach is an attempt to realign bank regulation and supervision with the commercial realities faced by banks and this involved institutions managing their risks in a more efficient way to reflect the increase in modes of obtaining finance for business and also to hedge risks.[333] The risk based approach in the USA concentrates on both small 'community banks' and 'large banks' and the mode of supervision has developed in distinct ways as a result of the existence of more than one bank regulator at the federal level.[334]

The risk based approach consolidates on the extent to which a risk could adversely affect the safety and soundness of a bank.[335] Benefits of the OCC's risk based approach include:[336] Core assessment criteria which assist the OCC in its application of a common methodology to evaluate the risk profile of individual group entities to ensure that risks can be measured consistently and ; the forward looking and proactive nature of the OCC's approach which enables it to gauge how risks will change over the next 12 months.

7.8.1 Impact of Basel II on US Financial Regulation and Supervision

Basel II is important not only because it is a common standard for measuring capital adequacy but also because it is based on the risks of an institution's investments.[337] It therefore allows for greater facilitation of harmonisation and easier comparisons between different countries, particularly at a time when globalisation and the increase of multinational firms has made this necessary. The risk based capital standards not only mandate institutions that assume greater risk to have higher levels of capital but also take into consideration risks associated with operations that are not included on a bank's balance sheet, such as those risks resulting from obligations to make loans.[338] Basel II has been pursued by the Federal Reserve due to the increasing inadequacies of Basel I regulatory capital rules particularly in the context of the growing complexity of products and services provided by large internationally active banks.[339] A more risk-capital framework has been called for and it is

[333] D Singh, 'The Legal Aspects of Prudential Supervision' 2007 p 129
[334] ibid
[335] ibid p 130; The OCC sets out its policy on supervision of national banks in its Comptrollers Handbooks of 1996 and 2001. It emphasises that the supervisory process does not seek to restrict risk taking but that it expects banks to maintain such risk taking by having appropriate risk management processes available to capture those risks. Also see OCC *Large Bank Supervision, Comptrollers Handbook*, (2001) at p. 3
[336] D Singh, 'The Legal Aspects of Prudential Supervision' 2007 p 131
[337] *The Federal Reserve System, Purposes and Functions* p 73
[338] ibid
[339] See 'An Update on Basel II Implementation in the US', 'Reasons for Basel II', 'Remarks by Governor Susan Schmidt Bies at the Global Association of Risk Professionals Basel II Summit, New York, February 27 2007 <http://www.federalreserve.gov/boarddocs/speeches/2007/20070226/default.htm> last visited February 27 2007

believed that Basel II would provide such framework for such internationally active banks.[340] As banking involves the acceptance and management of risks, it is of great importance that bank supervisors ensure that an adequate level of capital is maintained to insulate itself against potential losses. Minimum regulatory capital requirements are vital to ensuring that such protection is facilitated.[341]

On the 25th of September, 2006, the Office of the Comptroller of the Currency, Treasury (OCC); Board of Governors of the Federal Reserve System (Board); Federal Deposit Insurance Corporation (FDIC); and Office of Thrift Supervision, Treasury (OTS), which are collectively known as the Agencies, issued a notice of proposed rule making (NPR or proposed rule).[342] This notice welcomes comments on the New Advanced Capital Adequacy Framework that will replace the present general risk-based capital standards which have been applied to large, internationally active US banks.[343] The proposed framework would also implement the "International Convergence of Capital Measurement and Capital Standards: A Revised Framework," which was published in June 2004 by the Basel Committee on Banking Supervision (Basel II) in the US.[344] Basel II consists of three pillars namely: capital adequacy requirements, centralized supervision and market discipline.

In relation to Pillar 1, the proposed framework as described in the NPR, would require some qualifying banks and permit others to calculate their regulatory risk-based capital requirements using an internal ratings-based (IRB) approach for credit risk and the advanced measurement approaches (AMA) for operational risk.[345] As well as giving guidelines for the supervisory review process and requiring a process for the supervisory review of capital adequacy under Pillar 2, the NPR also highlights requirements for improved public disclosures under Pillar 3.[346]

Three documents lay out the proposed supervisory guidance for implementing proposed revisions to the risk-based capital standards in the US and this new capital framework would be compulsory for

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340 ibid

341 ibid

342 See 'Proposed Supervisory Guidance for Internal Ratings-Based Systems for Credit Risk, Advanced Measurement Approaches for Operational Risk, and the Supervisory Review Process (Pillar 2) Related to Basel II Implementation. <http://www.federalreserve.gov/boarddocs/press/bcreg/2007/20070215/attachment.pdf> last visited 20th February 2007

343 ibid

344 Ibid; Even though Basel II lists various possible approaches for calculating regulatory risk-based capital requirements under Pillar 1, the US has proposed only the advanced approaches for implementation.

345 Ibid; The internal ratings -based approach and advanced measurement approaches are both known as the advanced approaches.

346 ibid

large internationally active US banking organisations and optional for other institutions.[347] Two of these documents relate to the Basel II advanced approaches for calculating risk-based capital requirements namely, the advanced internal ratings-based (IRB) approach for credit risk and the advanced measurement approaches (AMA) for operational risk.[348] Under the IRB framework, internal estimates of certain risk components would be used as key inputs by banks in determining their regulatory risk-based capital requirement for credit risk.[349] As well as updating and consolidating previously proposed supervisory guidance on corporate and retail exposures, the IRB Guidance also provides new guidance on systems which a bank may require in order to distinguish risks posed by other types of credit exposure.[350]

The second guidance document provides supervisory guidance on the AMA for operational risk and updates the proposed AMA Guidance published in 2003.[351] The third document, issued for the first time, sets out proposals for guidance on the Basel II supervisory review process for assessing capital adequacy.[352]

7.9 Third Investigative Aim: The Role of the External Auditor in Banking Regulation and Supervision

The degree of external auditors' involvement in bank regulation and supervision varies across different jurisdictions. In the US, periodic on-site examinations are carried out and justified on the basis of the large number of small banks and on unit banking within particular states.[353] Unlike jurisdictions where authorities place reliance on outside experts, bank supervisors in the US must possess skills in order to evaluate asset quality and other areas governing a bank's activities.[354] There is no formal statutory based relationship between the supervisors and external auditors in

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[347] See 'Agencies Seek Public Comment on Proposed Supervisory Guidance for Basel II' <http://www.federalreserve.gov/boarddocs/press/bcreg/2007/20070215/default.htm>

[348] ibid

[349] See 'Proposed Supervisory Guidance for Internal Ratings-Based Systems for Credit Risk, Advanced Measurement Approaches for Operational Risk, and the Supervisory Review Process (Pillar 2) Related to Basel II Implementation. <http://www.federalreserve.gov/boarddocs/press/bcreg/2007/20070215/attachment.pdf> last visited 20th February 2007

[350] ibid

[351] ibid

[352] See 'Agencies Seek Public Comment on Proposed Supervisory Guidance for Basel II' <http://www.federalreserve.gov/boarddocs/press/bcreg/2007/20070215/default.htm>

[353] V Polizatto, 'Prudential Regulation and Banking Supervision: Building an Institutional Framework for Banks' (January 1990) World Bank Working Paper p 17

[354] ibid

countries such as the USA and Italy.[355] Supervisors in these countries depend on direct inspections which they themselves carry out and commercial law governs the appointment of bank auditors.[356] In the UK and Germany, the banking supervisor has statutory powers over the appointment of external auditors, such as the right of approval or removal, and the right to commission an independent audit.[357]

The benefits of using the external auditor in the bank regulatory and supervisory process include the ability of the external auditor to provide a wide range of resources and knowledge and acting as an intermediary for the regulator, thereby helping to protect the regulator's reputation and avoiding regulatory capture. The risks involved in using the external auditor include conflict of interests[358], loss of information during the transfer of information to the regulator and higher costs.[359] This investigative aim, in addition to providing a descriptive analysis of the audit professions of selected jurisdictions, considers the safeguards in place to mitigate those risks emanating from the use of external auditors in the supervisory process.

7.9.1 The German Audit Profession

Individual financial statements and annual reports for German stock corporations are required to be prepared in accordance with the German Commercial Code.[360] Section 264 paragraph 1 sentence 1 of the German Commercial Code requires the executive board to prepare individual financial statements.[361] In addition, stock corporations must also prepare annual reports unless it is a small corporation under the definition of section 267 of the Commercial Code.[362] Audits are carried out on two levels. Whilst the audit of financial statements and the annual report is performed by the

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[355] E Huepkes, 'The External Auditor and the Bank Supervisor: Sherlock Holmes and Dr Watson?' (2005) 7 No1/2 Journal of Banking Regulation 10 ; Italy has a statutory auditor though

[356] ibid

[357] ibid; See German Banking Act section 28; FSMA 2000 section 166

[358] The external auditor in this situation would not only owe obligations to the bank, its shareholders but also to the regulator and those investors whose interests are being safeguarded by the regulator.

[359] E Huepkes, 'The External Auditor and the Bank Supervisor' p 12

[360] Federation des Experts Comptables, *Europeens Enforcement Mechanisms in Europe: A Preliminary Investigation of Oversight Systems* (April 2001) 33

[361] Ibid; The corporate governance structure for stock corporations (*Aktiengesellschaft)* in Germany is based on the executive board (*Vorstand)* and the supervisory board (*Aufsichtsrat)* which oversees the executive board.

[362] Ibid p 33; Privately-held German stock corporations that fulfil certain size criteria and publicly-traded German stock corporations (*Aktiengesellschaft*) are required to have audits; HA Skaife and J Gassen, 'Can Audit Reforms Change the Monitoring Role of Audits? August 2006

statutory auditor[363], the individual and consolidated financial statements, as well as the annual report of a stock corporation are subject to examination by the supervisory board of the company.[364] The statutory audit results in two documents being issued namely:[365] The audit report which is published along with the financial statements and the confidential audit report known as the long-form audit report. Whilst the audit report which is addressed to the public contains a summary of the overall conclusion reached in the audit by the auditor, the long form audit report provides detailed conclusions and is addressed to the supervisory and executive board.[366] The audit carried out by the supervisory board is more comprehensive than that of the statutory audit.[367] Upon the supervisory board's consent of the financial statements, the individual financial statements are usually approved and rarely require an approval by the general meeting.[368] The audit of the individual financial statements by the statutory auditor is however, subject to approval.[369]

The audit objective in Germany is the identification and public disclosure of irregularities and omissions and arriving at an opinion on the firm as a going concern.[370] Whilst the first paragraph of the published audit report states that the audit was conducted accordingly with section 317 of the German Commercial Code and that the audit abides by the professional standards of the Institut der Wirtschaftspruefer, the last paragraph states that the financial statements present fairly the financial position, operating activities and cash flows of the firm accordingly with generally accepted accounting principles.[371]

7.9.2 Growing Perception of Auditor Independence in Germany?

Since 1931, when the audit profession started being regulated, outsiders, in particular credit institutions, have been giving up their stakes in firms of partnerships (Wirtschaftspruefer, WP).[372] Apart from the growing realisation that outside ownership was not popular internationally, there

363 Section 316 para 1 sentence 1 and paragraph 2 of the Commercial Code; see Federation des Experts Comptables Europeens 'Enforcement Mechanisms in Europe: A Preliminary Investigation of Oversight Systems' April 2001p 33

364 Section 171 para 1 sentence 1 German Stock Corporation Law ; see Federation des Experts Comptables Europeens, *Enforcement Mechanisms in Europe: A Preliminary Investigation of Oversight System* (April 2001)33

365 HA Skaife and J Gassen 'Can Audit Reforms Change the Monitoring Role of Audits? August 2006

366 Federation des Experts Comptables Europeens, *Enforcement Mechanisms in Europe: A Preliminary Investigation of Oversight Systems* (April 2001) 33

367 ibid

368 Section 172 of the German Stock Corporation Law

369 ibid

370 HA Skaife and J Gassen, 'Can Audit Reforms Change the Monitoring Role of Audits? August 2006

371 ibid

372 L Evans and C Nobes, 'Harmonisation of the Structures of Audit Firms: Incorporation in the UK and Germany' (1998)7 (1) European Accounting Review 139

was also growing doubt as to whether firms which were partly owned by outsiders promoted auditor independence.[373] However, there is now a growing trend of audit services being provided by non audit owners in Germany. Medium sized partnership firms (Wirtschaftspruefer) are being founded by non auditors – in particular members of the consultancy profession wishing to offer their clients the additional service of an audit.[374] Even though the 8th Directive has achieved some degree of harmonisation in that both Germany and the UK now permit incorporation, the legislation regarding ownership of audit firms presents a reversal of the original situation.[375] As a result of changes arising from the implementation of the 8th Directive, there have been questions raised in relation to changing perceptions of auditors and audit in both countries – whether there is growing focus on commercialism in the UK and whether there is growing focus on independence and professionalism in Germany.[376] A higher perception of audit independence in Germany is probably long overdue following criticisms of auditors' independence.

7.9.3 Auditor Rotation

Auditor rotation has been a topic of considerable debate – particularly in jurisdictions such as Germany. The debate usually centres around the alleged costs of implementing and carrying out mandatory audit rotation and also the claim that quality of audits will fall.[377] An issue for consideration in Germany is whether the audit liability level is high enough to make up for the lack of mandatory audit rotation. However, there may be dangers in using only liability levels to ensure independence – especially where liability levels become too high.[378] It is also important to note that just as mandatory rotation can reduce legal liability in thin markets, it will also tend to increase legal liabilities in developed markets.[379]

In audit markets with relatively few large clients (thin markets), it has been proved that the resulting improved incentives for independence (benefits from mandatory rotation) outweighs the cost of carrying out mandatory rotation.[380] This is because mandatory rotation can reduce legal liability in

373 ibid
374 ibid
375 Ibid p 140
376 ibid
377 MB Gietzmann and PK Sen, 'Improving Auditor Independence Through Selective Mandatory Rotation' (2002) 6 International Journal of Auditing 199
378 Ibid p 185

379 Ibid p 198

380 Ibid p 183

such markets. In addition, there is greater concern for reappointment in thin markets and hence there would be greater likelihood that an auditor would be more willing in such markets, to compromise his independence. If audit markets are thin, independence can still be attained with lower level of legal liability under mandatory rotation than in a case where rotation is not mandatory.[381]

Gietzmann and Sen also argue that in contrast, auditors' potential gains from establishing and sustaining a reputation for independence supersedes the gains of reappointment with a particular client where a more developed audit market with many potential new clients exists.[382] These results occur because in a sufficiently thin market, the auditor's reputation is not a strong incentive as there relatively few new clients and in addition, opportunities to replace the existing client base are limited, no matter how good that auditor's reputation is.[383] As a result, it is concluded that if audit markets are thin, rotation is desirable.[384]

Germany has been classed as having a relatively thin market as relatively few companies are public limited companies (AGs).[385] Private limited companies (GmbH) are more dominant with only a section of these companies requiring statutory audits.[386] The German legislature has considered an active reform on the regulation of auditors and possible introduction of auditor rotation.[387]

7.10 Safeguarding the Auditor's Independence in Italy

In Italy, the Board of Directors are required to prepare annual financial statements according to Article 2423 of the Italian Civil Code.[388]

Focus on internal audits: enough focus on external audits?

The concept of the external audit, is not as developed in Italy when compared to Germany and

381 ibid p 185
382 ibid
383 Ibid p 185
384 Ibid p 199
385 Ibid p 201

386 ibid
387 ibid p 200
388 This was modified by the Legislative Decree no 127 of the 9 April 1991 which incorporated the Fourth and Seventh EEC Directives. In addition, Article 25 of the Legislative Decree requires parent companies' Board of Directors to prepare consolidated financial statements unless certain s conditions exempt them from doing so, as indicated in Article 27 of Legislative Decree no 127.

Britain.[389] Presidential Decree No 136 of 1975, whose source is the Law 216/1974, brought into force for the first time the requirement for the external audit of listed company financial statements in Italy.[390] External audit is differentiated from the traditional Collegio Sindicale or simply *sindaci* (internal) audit through legislative restrictions.[391] In contrast to the present European trend whereby there seems to be a relaxing approach on standards of auditor independence, Italy has adopted a more stringent approach to provisions on auditor independence.[392] CONSOB plays a significant role in regulating external audit of listed companies and its involvement appears to have resulted in stricter provisions for ensuring that auditors carry out their responsibilities in an objective manner and that they are seen as doing so.[393]

In 2001, the quality of internal control systems formed a focal point during prudential analysis and particular importance was given to verifying the effectiveness of internal audits.[394] Internal auditing is considered to be in a phase whereby it assumes an approach to inspection that is not well positioned to assessing the effectiveness of the internal control system.[395] The process involves mainly checking operations of branches and verifying compliance with internal rules – audit controls on central structures and process analysis are considered to be inadequate.[396]

Apart from certifying compliance with prudential requirements, the supervisory process has also involved greater focus on the effective control of risks.[397] The growth of foreign connections of large banks has resulted to special supervisory action aimed at dealing with risks of subsidiaries overseas.[398] In addition, increasing utilisation of credit derivatives for hedging and trading activities has warranted a check on measures whereby risks are calculated and managed.[399]

389 JE Stevenson, 'Auditor Independence: A Comparative Descriptive Study of the UK, France and Italy'(2002)6 (2) International Journal of Auditing 176
390 Ibid pp 163,164
391 Ibid p 176
392 Ibid p 177
393 ibid
394 See 'Supervision of Banks and Other Intermediaries : Banking Supervision", Bank of Italy at p 206 <http://www.bancaditalia.it/vigilanza_tutela/vig_ban/pubblicazioni/rela/2001/Supervision.pdf> last visited Jan 20 2007
395 ibid
396 ibid
397 Ibid p 207
398 ibid
399 ibid

7.10.1 The Audit Profession in Italy

There are two types of statutory auditors in Italy namely:[400] The *Collegio Sindicale* – this type of statutory auditors (a board of three or five members chaired usually by their senior), has more of a management supervisory role than an auditing role and as such, does not carry out a full audit but monitors proper administration of the entity and its compliance with rules.[401] Audits by the *Collegio Sindicale* must be carried out on all limited liability companies who appoint the *Collegio Sindicale* and whose share capital exceeds around 103,000 Euros.[402] Full auditors are empowered to carry out full audits and according to the law, companies subject to mandatory full audits have to employ the services of both *Collegio Sindicale* and a full auditor.

7.10.2 Audit of Financial Statements In Italy

The Italian 1942 Civil Code mandated capital-based companies requiring a statutory audit to appoint a board, "Statutory Board of Auditors" (*un Collegio Sindacale*) of between 3 and 5 individual auditors (*Revisori Contabili*) to carry out an 'institutional internal audit'.[403] The Civil Code, Article 2488 states that the *Collegio Sindacale* must be appointed if certain conditions relating to size of the company[404], share capital are met.

For the first time in Italy, through the Presidential Decree No 136 of 1975, the requirement for the external audit of listed companies was introduced under the *Il Commissione Nazionale per le Societa e la Borsa* (CONSOB) – the stock exchange regulatory authority.[405] This compulsory external audit requirement has since been extended to a wide range of entities such as state-owned companies.[406] The *L'Ordine dei Dottori Commercialisti* (graduates in Economics and Commerce) and *L'Ordine dei Ragionieri e Periti Commerciali* (College of Accountants and Commercial Experts – high school diploma) supported the continued existence of the traditional audit board (sindaci) in the interests of most of its members.[407] As a result, Decree no 127 in 1991 whilst

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400 M Cameran, 'Audit Fees and the Large Auditor Premium in the Italian Market' (2005) 9 (2) International Journal of Auditing 131

401 See JE Stevenson, 'Auditor Independence: A Comparative Descriptive Study of the UK, France and Italy'(2002)6 (2) International Journal of Auditing 163 and also M Cameran 'Audit Fees and the Large Auditor Premium in the Italian Market' (2005) 9 (2) International Journal of Auditing 131

402 ibid

403 J Stevenson, 'Auditor Independence: A Comparative Descriptive Study of the UK, France and Italy' International Journal of Auditing p 163

404 As set forth in article 2345 bis of the Civil Code; see Federation des Experts Comptables Europeens *Enforcement Mechanisms in Europe: A Preliminary Investigation of Oversight Systems* (April 2001)40

405 J Stevenson, 'Auditor Independence p 164

406 ibid

407 ibid

imposing a statutory external audit requirement on some classes of businesses, allowed for continued operation of the sindaci.[408]

Whilst the *Collegio Sindacale* is mandatory for all companies where an audit of the accounts is required, the use of external auditors is compulsory only in companies which are required to get an audit opinion.[409] The audit company must be authorised by the Security and Exchange Commission, CONSOB.[410] In outlining the responsibilities of the Board of Statutory Auditors, the Italian Civil Code did not distinguish between listed and non listed companies.[411]

The *Collegio Sindicale* performs audits restricted to particular account balances and fiscal/social security areas and as a result, duties of the Collegio Sindicale and those of full auditors overlapped.[412] The Draghi law (Decreto Legislativo 24 febbraio 1998 no 58 – Decreto Draghi) attempted to clarify the apparent overlap of audit duties between the sindaci and the societa di revisione [413] in listed companies by making inapplicable almost half of the Civil Code provisions for sindaci in these companies.[414] It addresses the overlap of audit duties for some companies (more importantly for the listed companies), in that the Collegio Sindicale of some of the companies subject to the Draghi law have no audit responsibilities – these responsibilities having been transferred to external accountancy firms.[415]

In relation to non listed companies, the Italian Civil Code[416] states that the Board of Statutory Auditors must perform operations to verify the correctness of accounting, cash accounts, existence

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408 ibid

409 Federation des Experts Comptables Europeens *Enforcement Mechanisms in Europe: A Preliminary Investigation of Oversight Systems* (April 2001) 43

410 ibid

411 Federation des Experts Comptables Europeens *Enforcement Mechanisms in Europe: A Preliminary Investigation of Oversight Systems* (April 2001)40

412 M Cameran, 'Audit Fees and the Large Auditor Premium in the Italian Market' (2005)9 (2) International Journal of Auditing 131

413 Practically the Italian branches of the Big Five

414 J Stevenson, 'Auditor Independence : A Comparative Descriptive Study of the UK, France and Italy' International Journal of Auditing 164

415 M Cameran, 'Audit Fees and the Large Auditor Premium in the Italian Market' (2005)9 (2)International Journal of Auditing 131

416 Article 2403

of investments and other assets of the company every three months.[417] As well as other proposals and provisions, the final report on the draft of financial statements should summarise activities and the results of such activities.[418]

Legislative Decree no 58 of the 24 February 1998 effective from the 1st July 1998 exempted some provisions included in the Italian Civil Code for listed companies and describes the roles and responsibilities of the Board of Statutory Auditors for listed companies.[419] These roles include the oversight of the company's compliance with the Italian Civil Code and Articles of Incorporation, the appropriateness of the administration which includes the internal system of controls and administrative functions.[420] The Board of Statutory Auditors are also required to report to CONSOB if they are aware of any irregularities during the performance of their control functions.[421] Irregularities relating to the directors' operations within the company can also be reported to any competent court.[422] All other areas required by the Italian Civil Code to be verified by the Board of Statutory Auditors became the exclusive responsibilities of the external auditors for the company.[423]

However, this law did not result in change for most companies operating in Italy.[424] It gave the societa di revisione sole responsibility for the control of client accounting – including verification of underlying accounting records, however the sindaci are still required to express and report an opinion on the financial statements.[425] Further change occurred through the reform of the Italian commercial law in 2001 whereby the possibility to appoint a full auditor (individual or audit firm) instead of a Collegio Sindicale was given in some cases.[426] This reform came into effect on 1 January 2004 and provided an option to the company to choose whether or not to employ an individual auditor or an audit firm instead of the Collegio Sindicale – thereby changing the

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417 Federation des Experts Comptables Europeens *Enforcement Mechanisms in Europe: A Preliminary Investigation of Oversight Systems* (April 2001) 41

418 ibid
419 ibid p 40
420 ibid pg 41
421 See Article 149 co 3 of the Legislative Decree no 58; ibid
422 ibid
423 Ibid p 41

424 ibid
425 J Stevenson, 'Auditor Independence : A Comparative Descriptive Study of the UK, France and Italy' International Journal of Auditing p 164
426 M Cameran, 'Audit Fees and the Large Auditor Premium in the Italian Market' (2005)9(2) International Journal of Auditing 131

obligation under prior legislation of limited liability companies to appoint a Collegio Sindicale (or according to the new law, a full auditor).[427]

The EC Eight Directive was implemented in Italian law in 1992 and as a result, the statutory auditor (*Revisore Contabile*) is required to be enrolled on a register held by the Ministry of Justice and hold one of two recognised professional qualifications.[428] One of the two professional qualifications must be from either *L'Ordine dei Dottori Commercialisti* (graduates in Economics and Commerce) or *L'Ordine dei Ragionieri e Periti Commerciali* (College of Accountants and Commercial Experts).[429] This objective was only partially achieved as whoever was *sindaco* for at least three years before the law was enforced, regardless of his school/academic qualifications, was automatically enrolled on the new register. These bodies appoint a commission (*Commissione per la Statuizione dei Principi di Revisione*) to issue auditing statements.[430]

In addition to statutory audit – that is, the external audit of listed companies and other bodies and the quasi-internal audit by *sindaci*, there is growing preference for voluntary audit in Italy due to many reasons and there are now more companies undertaking voluntary audits than there are companies for whom a statutory audit is required.[431] Individual auditors are allowed to perform voluntary audits.[432] The Civil Code[433] details provisions regarding accounting and auditing and with over 70,000 accounting professionals now in Italy, it has the second largest number of accounting professionals in Europe after the UK.

7.10.3 Safeguards in Operation to Reduce Threats to Independence

Two ethical guidelines are available to auditors in Italy depending on which professional body they belong to:[434] The *Consiglio Nazionale dei Dottori Commercialisti's* (CNDC) *Norme di Deontologia Professionale* which came into force in 1987 and whose revised January 2001 version has been used and

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427 ibid
428 J Stevenson, 'Auditor Independence: A Comparative Descriptive Study of the UK, France and Italy' International Journal of Auditing p 163
429 ibid
430 ibid
431 Ibid p 164
432 ibid
433 *Codice Civile e Leggi Collegate 1995/96*
434 J Stevenson, 'Auditor Independence: A Comparative Descriptive Study of the UK, France and Italy' International Journal of Auditing p 168

the *Consiglio Nazionale dei Ragionieri Commercialisti's* (CNRC) *Codice Deontologico* which was approved in October 1999

The CNDC document is composed of 40 articles which cover three sections namely general principles, external relations and internal relations. Independence and objectivity are covered first under general principles before integrity and confidentiality but are not defined.[435]

The CNRC's *Codice Deontologico* is more comprehensive than the previously issued 1983 version and it has been influenced by the IFAC and FEE codes insofar as they are compatible with Italian legislation. As is the case in the UK, emphasis in the CNRC's code is placed on objectivity rather than independence and on an independent frame of mind rather than the appearance of independence.[436]

Since 1995, auditors (*revisori)* have to be qualified members of either the CNDC or CNRC and are automatically bound by their codes.[437] In addition, external auditors of listed companies are bound by CONSOB's comprehensive regulations.[438] CONSOB performs quality reviews of the *societa di revisione* regularly[439] in order to monitor independence and technical fitness.[440] As a result of this process, CONSOB consults with the councils of the two professional bodies with the aim of providing recommending changes to their practice and therefore plays an important role in external auditing in Italy.[441] Not only does it have the authority to remove any firm contradicting its regulations from the register, but also, registered firms are required to submit detailed documentation to CONSOB as part of its quality review process.[442]

7.10.4 Auditor Rotation

According to the data obtained for Italy, Italy is classified as having a relatively thin market for external auditors.[443] As a result, mandatory rotation would and should be desirable in Italy where

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435 J Stevenson, 'Auditor Independence: A Comparative Descriptive Study of the UK, France and Italy' International Journal of Auditing p 168

436 ibid

437 ibid

438 ibid

439 Articles 162 and 163 of the *Decreto legislativo 24 febbraio 1998*

440 J Stevenson, 'Auditor Independence: A Comparative Descriptive Study of the UK, France and Italy' International Journal of Auditing p 168

441 ibid

442 ibid

443 MB Gietzmann and PK Sen, 'Improving Auditor Independence Through Selective Mandatory Rotation' (2002) 6 International Journal of Auditing 200

external auditors are concerned. Interestingly enough, mandatory rotation in Italy applies only to external auditors.[444] Italy is the only EU Member State to require rotation of audit firms for listed clients as well as for other bodies such as insurance companies.[445]

7.10.5 EC Consultative Paper

The EC Paper has evolved from an examination of the FEE Common Core Principles (FEE 1998) and has maintained not only the framework developed by FEE but that also common to the UK guidance whereby five threats to independence are recognised and a range of safeguards are offered to reduce these threats.[446] The EC document however, addresses issues on auditor independence more deeply than either the UK or FEE codes.[447] It also adopts the use of the principles based approach over a rules based approach as this promotes greater flexibility in dealing with issues related to auditor independence.[448] The European Commission has developed a two way approach by advancing a common set of principles governing the issue of auditor independence on the one hand, and tightening up the monitoring of audit quality within the EU on the other.[449]

7.11 Auditor Independence in the US

In the US, developments relating to the issue of auditor independence have led to the Securities and Exchange Commission (SEC) carrying out investigations in situations where conflicts of interests are apparent among major audit-consultancy firms.[450] The preservation of the independence of external auditors is considered vital to investor protection – as a result, the Securities and Exchange Commission and AICPAC (American Institute of Certified Public Accountants) set up the

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444 Ibid p 200

445 J Stevenson, 'Auditor Independence : A Comparative Descriptive Study of the UK, France and Italy' International Journal of Auditing pp 172,173

446 J Stevenson, 'Auditor Independence: A Comparative Descriptive Study of the UK, France and Italy' International Journal of Auditing p 169

447 ibid

448 Ibid

449 Ibid

450 J Stevenson, 'Auditor Independence : A Comparative Descriptive Study of the UK, France and Italy' International Journal of Auditing p 157

Independence Standards Board (ISB).[451]

In the aftermath of Enron, the Co-ordinating Group on Audit and Accounting Issues (CGAA) comprising regulators and ministers was formed by the UK government.[452] The chairman and the director of the Accountancy Foundation Review Board (Review Board), were both members of the CGAA – the Board being responsible then for the independent oversight of the UK accountancy professional bodies.[453] The Review Board in ensuring that policy discussions on the topic of auditor independence were well informed commissioned a research programme in collaboration with leading academics and market research bodies.[454] Of great concern to the CGAA was the adequacy of the UK framework for auditor independence particularly given the circumstances which led to criticism of Andersen.[455] These criticisms are as follows: The fact that the income generated by Andersen from non-audit services ($27 million) was greater than that from audit services ($25m); that Enron had been the partner's only client for some years and was the main client of the firm's Houston office – hence making the office and partner economically dependent on keeping Enron as a client; and a number of former staff of Andersen worked for Enron. [456]

Enron's accounting practices had overstated revenue from long term contracts and Andersen's errors of judgment in the audit of Enron were admitted by Joseph Berardino, Andersen's CEO before Congress in December 2001. [457] As well as highlighting the importance of financial transparency in the adequate functioning of capital markets, the Enron case also demonstrates the conflict of interest faced by auditing firms where the same firm performs both the internal and external audits for the client firm and when the auditing firm also provides lucrative consulting services to the client.[458]

As regards non-audit services, the Review Board makes two recommendations:[459] Firstly, for a

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451 ibid

452 S Fearnley and V Beattie, 'The Reform of the UK's Auditor Independence Framework after the Enron Collapse: An Example of Evidence-based Policy Making' (2004) 8 International Journal of Auditing 117

453 ibid

454 ibid p 118

455 ibid

456 ibid

457 U Sridharan, W Royce Caines, J McMillan and S Summers, 'Financial Statement Transparency and Auditor Responsibility: Enron and Andersen' (2002) 6 (3) International Journal of Auditing 281

458 ibid p 284

459 S Fearnley and V Beattie, 'The Reform of the UK's Auditor Independence Framework after the Enron Collapse: An Example of Evidence-based Policy Making' (2004) 8(2) International Journal of Auditing 132

prohibition to be introduced which would disallow auditors from providing advice to management where this had adverse effects for investors and secondly, that those permissible non-audit services presently in operation be reviewed and where threats to independence were significant, discontinuation of such services should be considered .[460] Four further recommendations by the Review Board include the vesting of responsibility for the UK auditor independence framework in the Auditing Practices Board, that the level of economic dependence for one audit client be reduced to 5% of total practice fees, a suggestion for wide review to be undertaken on the change of appointment procedures and fourthly that the monitoring regime should extend its scope to cover the management of economically significant clients.[461]

7.12 Fourth Investigative Aim: The Audit Expectations Gap

In countries like Italy and Germany where users of financial information are mainly bankers, governments or founding families, where there are relatively few listed companies (when compared to the US and the UK),[462] the expectations gap in these jurisdictions can be ascertained through the **characteristics of the users of financial information**.

Based on the uniformity of accounting rules, strong **enforcement procedures** which exist in the US,[463] this would tend to reduce the expectations gap which exists in the US when compared to the EU and jurisdictions within the EU.

Based on users of financial information however, countries such as Italy and Germany comprise mainly of core, insider shareholders[464] hence the expectations gap is more likely to be reduced than the case of the UK and the US where there are many outside shareholders.

In addition, the type of legal system (be it common law based or codified) is likely to have an impact on the expectations gap as the law can be said to be more well defined in codified systems in comparison to common law systems. These differences between credit/insiders (Germany and Italy) and equity/outsiders (the UK and the US) shareholders and the legal systems may be determining factors in the expectations gap within these jurisdiction. The situation however, is not so clear cut.

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460 ibid
461 ibid
462 C Nobes and R Parker, *Comparative International Accounting* p 22
463 See ibid p 46
464 Ibid p 24

Institutional and private investors now have an increasing importance in Germany[465] and as mentioned in the second chapter, the Italian and German governments have realised the growing importance of audits and requiring public or listed companies to publish detailed, audited financial statements.

Litigation and legal exposure risks created by the expectations gap has led to great concerns for the international auditing community.[466] Such are those concerns that the implementation of "expectations gap" auditing standards has taken place in the US.[467] In addition, legislation relating to proportionate legal liability for auditors, the Private Securities Litigation Reform Act, was passed by the US Congress in 1995.[468] Management fraud and bankruptcy are two important audit contexts which not only present considerable legal exposure to the audit profession but have also been directly addressed in both international and US auditing standards.[469] The Private Securities Litigation Reform Act[470] does not emphasise the significance of these two contexts since it requires audits of public companies not only to include procedures that will ensure the detection of fraud having a direct and material effect on the financial statements, but also an assessment of an entity's ability to continue as a going concern, hence avoiding bankruptcy.[471]

Litigation concerns have increased following the demise of Arthur Andersen, as a result of the Enron scandal. According to a European Commission policy paper due for publication in January 2007, the big four audit firms needed legal protection against potentially damaging legal actions.[472] Four ways whereby Brussels could enhance protection for auditors as suggested by the Commission paper are as follows:[473] Firstly, through the imposition of a fixed monetary cap for auditor liability at European level via EU legislation; secondly, by introducing a cap based on the market capitalisation of the audited company; thirdly, the proposal of a cap based on a multiple of the audit

465 Ibid p 23

466 B Anderson, M Maletta and A Wright, 'Perceptions of Auditor Responsibility: Views of the Judiciary and the Profession' (1998) 2(3)International Journal of Auditing 215

467 Ibid p 216

468 Ibid; The Act establishes conditions for auditor liability dependent on proportionate responsibility as opposed to joint and several liability which was stipulated by previous US law.

469 Ibid p 217; See ISA No 240 (International Federation of Accountants 1996a), ISA No 570 (International Federation of Accountants 1996d), SAS No 59 (American Institute of Certified Public Accountants, 1988d) SAS No 82 (American Institute of Certified Public Accountants 1997); ibid.

470 Title III

471 B Anderson, M Maletta and A Wright, 'Perceptions of Auditor Responsibility: Views of the Judiciary and the Profession' (1998) 2 (3)International Journal of Auditing 217

472 T Buck 'Brussels Suggests Legal Shield for Big Audit Firms' *Financial Times* January 18 2007

473 ibid

fees charged by the auditor to his client; and fourthly, through the principle of "proportionate liability" which can only be implemented by national governments. Under the principle of proportionate liability, auditors would only be liable for damages resulting from their own mistakes and not their clients'. At present, a liability cap exists in just five EU member states namely Germany, Austria, Belgium, Greece and Slovenia.[474] Britain, in the meantime, is implementing the concept of "proportionate liability".[475]

Expectations gap contribute to litigation risk because differences in perceptions between the judicial and audit profession, particularly with regards to the issue of materiality, are likely to result to a higher level of litigation risk – since judges' lack of consideration of materiality levels are likely to subject less culpable auditors to less favourable judicial decision making.

As well as evidence shows that certain external factors from the audit environment, held to be highly important by auditors are considered by the judiciary in deciding responsibility assessments and mitigate the effects of judges' unfavourable attitudes towards the auditing profession, it has also been shown that whilst reliability and materiality greatly influenced auditors' attributions, they did not play a part in the attributions of the judges.[476] Findings show that whilst the audit profession attaches great importance to materiality issues in addressing audit responsibility in a fraud case, judges do not appear to take into consideration whether a fraud is above or below the auditor's materiality level.[477] If factors such as materiality play such a role in the audit standards, then judges should also consider these factors during responsibility assessments of auditors.

In Germany, auditor legal liability is capped at a maximum amount and whilst there are pressures in other jurisdictions (such as the UK)[478] to pass limited liability legislation, German auditors sought to increase the cap on audit liability in order to avoid broader unlimited responsibilities to third parties.[479] Unique factors which exist in Germany include the close relationship of all professional

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474 ibid

475 ibid

476 B Anderson, M Maletta and A Wright, 'Perceptions of Auditor Responsibility: Views of the Judiciary and the Profession' (1998) 2 (3) International Journal of Auditing 218

477 Ibid p 227

478 However this has changed with the Companies Act 2006, which has removed the previously existing limits on auditor liability and compelled an agreement between the company and the auditor. See Sections 534 – 536 Companies Act 2006

479 B Anderson, M Maletta and A Wright, 'Perceptions of Auditor Responsibility: Views of the Judiciary and the Profession' (1998) 2(3) International Journal of Auditing 229

groups within the state, the strong influence of banks and conservative accounting.[480] These factors are said to have accounted for the acceptance of capped audit liability arrangement over the past 60 years and for the initiative by auditors in seeking to increase the cap in order to avoid broader, unlimited responsibilities to third parties.[481] In April 1998, through amendments made to the German Commercial Code, audit reforms made effective for fiscal years ending after December 31 1998, became law.[482] As well as changing the objective of the audit, the audit reforms refined audit reporting requirements, and increased the legal liability of auditors.[483] The legislation resulting from the reforms increased the legal liability limits of audit failures from 250,000 Euros to 4 million Euros.

7.13 Comparative Analysis

7.13.1 Comparative Analysis between Germany and the UK

7.13.1.1 First Investigative Aim

The Central Bank's Involvement in Supervision in the UK and Germany

BaFin and the *Deutsche Bundesbank* share responsibilities for banking supervision and this division of responsibilities is aided through a Memorandum of Understanding. The FSA, HM Treasury and the Bank of England also co-operate through a Memorandum of Understanding[484]. Reasons for HM Treasury's involvement are probably historical – the Bank of England's relationship with the Treasury dating as far as 1946 through the Bank of England Act 1946. A more direct involvement between the Bank of England and the FSA (rather than the existing tripartite one) would have been preferable – especially through the Bank of England's greater participation in the supervisory process. The Memorandum of Understanding aids accountability in the supervisory process – even

480 M Gietzmann and R Quick, 'Capping Auditor Liability: The German Experience' 1996. See <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2580> (last visited 17th February 2007)

481 Also see B Anderson, M Maletta and A Wright, 'Perceptions of Auditor Responsibility: Views of the Judiciary and the Profession' International Journal of Auditing 1998 p 229

482 HA Skaife and J Gassen, 'Can Audit Reforms Change the Monitoring Role of Audits? Evidence from the German Audit Market.' August 2006 see also <http://www.papers.ssrn.com/sol3/papers.cfm?abstract_id=933010#PaperDownload>

483 Ibid ; Before the audit reforms, the audit objective focused on the verification of the composition and existence of assets-in-place. The published audit report was a one paragraph opinion that consisted of a mandatory phrase that annual financial statements were in compliance with German law and German generally accepted accounting principles, and that the financial statements presented a true and fair view of the enterprise. The auditor could voluntarily add an additional paragraph to the published audit report in order to inform the public about a specific problem or limitation of the audit, but the structure or the content of the optional additional paragraph was not codified by law; ibid

484 Refer to chapter two for this

though more work is required in regards to clearer allocation of responsibilities, particularly in relation to when the Treasury should be involved.[485] The quality of the supervisory process would be greatly enhanced through the Bank of England's immense knowledge being effectively contributed to the supervisory process.

The exchange of information between the Bank of England and the FSA is a vital principle[486] since the Bank of England stands in a position whereby it can provide necessary information required for the FSA to function effectively. There should be more focus on exchange of information between the Bank of England and the FSA in order to involve the Bank of England on a greater level in the supervisory process. Effective and regular communication is therefore required in order to ensure that the Bank provides timely, accurate and complete information when required and requested for. The FSA also requires qualified and experienced staff who can recognise when such information is required.

7.13.1.2 Regulatory Objectives

In comparison to the UK, where the Financial Services Authority's statutory objectives govern the financial services industry, be it banking, insurance or investment activities, the regulatory objectives within the banking, insurance and securities sector in Germany have been retained. As these three regulatory objectives rank equally487, a situation could occur whereby conflicts arise as regards which regulatory objective should take priority. This presents a problem for the German system as there are no governing principles or guidelines to determine which objective should take priority – unlike the case which exists in the UK whereby section 2(3) of the FSMA 2000 exists.

7.13.1.3 The Structure of Single Regulators

In contrast to the UK where amalgamation of all previously existing financial services regulators, processes and objectives have taken place, Germany's structure of financial regulation consists of previously existing regulators still operating independently albeit under one regulator, BaFin. As a result, there is still no integrated supervisory approach in Germany yet[488] and as highlighted with conflicting objectives, this situation would also present opportunities for lack of coherence and

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485 See the Memorandum of Understanding between HM Treasury, the Bank of England and the Financial Services Authority (2006) paragraph 5

486 For more on these principles see he Memorandum of Understanding between HM Treasury, the Bank of England and the Financial Services Authority (2006) paragraph 1

487 See BaFin's Annual Report for 2004

488 See Deutsche Bundesbank Monthly Report (April 2005) p 55

inconsistencies when compared to the coherent system of the UK's FSA.

In order to resolve the inconsistencies arising from the fact that Germany has not adopted an integrated supervisory approach yet, it has been suggested that focus should be on close cooperation and an extensive exchange of information among the supervisory institutions in the various sectors.[489]

This exchange of information would follow two objectives namely:[490] To help improve the evaluation of cooperation with enterprises from the other financial sector in the case of sectoral individual supervision of an enterprise and secondly, to facilitate coordination between competent national supervisors in the deployment and evolution of the surveillance toolkit in connection with such one-stop finance strategies.

Enforcement Process

The audit reports produced by auditors of a German bank are submitted to the German *Bundesbank* for evaluation who then reports its findings to the BaFin. Safeguards inherent in the German system include: Firstly, the statutory obligations imposed on auditors to report to the regulator (BaFin) and the Bundebank any irregularities or causes for serious concern discovered during the course of their audits and secondly, that both BaFin and the *Deutsche Bundesbank* rely not only on direct on site review but also on off site review.[491]

In this respect, and from this level of enforcement Germany's supervisory process introduces more checks in its enforcement process than is the case in the UK – as the regulator and the central bank both review the work performed by external auditors. The UK like also Germany imposes statutory obligations on auditors to report any irregularities or causes for serious concern discovered during the course of their audits.[492]

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489 ibid p 56
490 ibid
491 E Huepkes p 11
492 See FSMA section 166 and the German Banking Act , KWG section 28

7.14 Second Investigative Aim

7.14.1 Treatment of Risk Concentration in the UK and Germany – Separate Supervision or Consolidated Supervision?

In contrast to the UK, where consolidated supervision exists, there is still no integrated approach to cross sector supervision of equivalent risks in Germany. The one stop financial services strategy on which the establishment of BaFin is based is reflected strongly in the "Risk Analysis and Finance Market Studies Department'.[493] In Germany, financial conglomerates play a greater role in the insurance sector where they account for a total of 52% of the gross premiums written.[494] In contrast, they play a less significant role in the banking sector.[495]

The focus of the supervisory regime in Germany concerns setting specific capital requirements at a financial conglomerate level and treating risk concentration to separate supervision.[496] Since there is still no integrated supervisory approach in Germany, there should be focus on close cooperation and extensive exchange of information between the supervisory institutions in the various sectors.[497] The provisions of section 7 of the Banking Act and section 84(4) No 2a of the Insurance Supervision Act on the exchange of information will facilitate such close cross-sector cooperation between BaFin's insurance and banking supervisory sections.[498] It is also vital to monitor interrelationships between these two sectors to ensure accurate assessment of their scope and relevance to the stability of the financial system.[499]

The main efficiency gain from using a single risk-based approach rather than having multiple systems operating in various parts of the industry is that the risks posed by individual sectors can be compared against one set of criteria.[500] A single approach does not necessarily indicate that all sectors of the industry present the same kind of risks or that they will give rise to the same degree of risk to the individual objectives or principles of regulation.[501]

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493 See 'Responsibilities and Objectives : Cross Sectoral Departments' <http://www.bafin.de/bafin/aufgabenundziele_en.htm>

494 'Supervision of Financial Conglomerates in Germany' Monthly Report April 2005 p 39

495 Ibid pp 39,40

496 Ibid p 40

497 Ibid p 56

498 Ibid

499 ibid

500 D Singh, 'The Legal Aspects of Prudential Supervision' 2007 p 133

501 ibid

7.15 Third Investigative Aim

7.15.1 Differences between the Audit and Accounting Profession in Germany and the UK

In addition to representing opposing accounting traditions, Germany and the UK have different legal systems.[502] Whilst the UK operates according to a common-law based legal system, Germany is based on codified Roman Law. This legal difference plays an important role inter alia on each country's interpretation of the 'true and fair view' principle.[503] In addition, there are differences in the sources of finance for enterprises and as a result, differences in the importance of capital markets.[504] German finance has traditionally been provided by banks (both as equity owners and as lenders) whilst in the UK, finance has been provided by external shareholders.[505] Understandably, this difference has led to greater importance and focus on audit and publication requirements in the UK.[506]

In Germany, there is a lower number of listed companies than in the UK.[507] In addition, share capital is less distributed and small investors are not as important.[508] As a result of these differences, there is more tendency for the German system to place greater emphasis on creditor protection whilst the UK system emphasizes shareholder protection.[509]

Vieten however questions differences which particularly relate to the distinction between statutory control in Germany and a strong profession in the UK – especially because of EU harmonisation.[510] He points out that the increased scope for government intervention in Britain has resulted to a situation which is increasingly resembling that of the German system.[511] Apart from this however, he notes that there are still more differences than similarities between the two systems – particularly their audit objectives.[512] Whilst the audit objective under German law is to test for accordance with

502 L Evans and C Nobes, 'Harmonisation of the Structure of Audit Firms: Incorporation in the UK and Germany' (1998) 7 (1)European Accounting Review at p 126
503 Ibid
504 ibid
505 Ibid p 127
506 ibid
507 Ibid p 141
508 ibid
509 ibid
510 Ibid p 127
511 H Vieten, 'Auditing in Britain and Germany Compared: Professions, Knowledge and the State' (1995) 4(3) European Accounting Review 495
512 ibid p 500; also see Federation des Experts Comptables Europeens 'Enforcement Mechanisms in Europe: A Preliminary Investigation of Oversight Systems' April 2001 p 33 : the purpose of the German audit is to provide a

the relevant legislation, that of the UK is to give an opinion on the true and fair view.[513]

7.15.2Concepts of "Auditing" and "Accounting"

One significant difference between the auditing professions in Germany and Britain is the existence of auditing as a distinct profession in Germany.[514] The Wirtschaftspruefer is a qualified auditor and in contrast to Britain, an accounting profession does not exist in Germany.[515] In Britain, auditors grew more dependent on the expertise of accountants over the years until the audit function became dominated by the accounting profession.[516] The concepts of "auditing" and "accounting" are often used interchangeably in Britain.[517] (One of the reasons why the dual role of external auditor/ reporting accountant) does not exist in Germany – roles are distinct, conflicts of interest better avoided).

Other differences between the accounting and auditing professions in Germany and the United Kingdom are as follows:[518] In Germany, the tax profession is separate although it overlaps, and it is larger than the accountancy body. In contrast the UK system includes those practising tax in its accountants' figure. A second tier auditing body for auditors permitted only to audit private companies (of vereidigte Buchpruefer) came into being in the late 1980s.

7.15.3Communication between Audit/Accounting Profession and Third Parties

In the UK, the auditor owes a duty to the company and following Caparo v Dickman to the shareholders as a body – not an individual person.[519] Under company law, the auditor can also make written representation to shareholders and can be heard at the general meeting if the directors try to remove him.[520] The Wirtschaftspruefer does not have such rights except in court proceedings – however, his right to make statements is limited by the duty of confidentiality he owes the

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statement as to whether or not the financial statements and the annual report are in accordance with authoritative accounting principles.

513 L Evans and C Nobes, 'Harmonisation of the Structure of Audit Firms: Incorporation in the UK and Germany' The European Accounting Review 127

514 Vieten p 146

515 ibid

516 ibid

517 ibid

518 C Nobes and R Parker, *Comparative International Accounting* p 27

519 Vieten p 153

520 ibid

company.[521] This is not to say that the auditor, under German law, cannot report irregularities. He has to do so by reporting to the management and supervisory board.[522]

7.15.4 Exercise of Professional Judgements

It is debatable as regards whether the *Wirtschaftspruefer* does exercise as much professional judgement as his UK counterpart as a system of common law exists in the UK as contrasted to codification which exists in Germany. However, since German law does not cover all cases, some measure of professional judgement would still be required from the *Wirtschaftspruefer*.

Some similarities however persist between the German and UK systems of regulation of auditors/accountants. As is the case in the UK[523], a dual system of state and self regulation operates in Germany.[524] The *Wirtschaftsprueferkammer* (chamber of auditors) was established in 1961 and assumes the form of a self-governing body but is supervised by the Federal Minister of Economics, whose approval is essential for amendments to its constitution.[525] The other important body in Germany is the *Institut der Wirtschaftspruefer*, the members' trade organisation.[526] Membership of this organisation is not only voluntary but also restricted to practising auditors only.[527]

Initially, there were no provisions for on-site inspection in Britain.[528] Subsequently, the auditor's role in facilitating monitoring was realised.[529] Regulators are now incorporating audit technology into their enforcement procedures.[530] Unlike financial regulators in the US however, British and German banking supervisors do not have large teams of inspectors investigating bank operations on-site. Instead, the external auditor contributes by monitoring.[531] Auditing is also considered as being less intrusive than inspection. Bank auditing goes beyond company law requirements.[532] As well as providing German regulators with attested annual financial statements, German bank auditors are also required to provide them with a more detailed report on the audit.[533] Confidential

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521 ibid
522 ibid
523 See chapter four
524 Vieten p 147
525 ibid
526 ibid
527 ibid
528 Vieten p 174
529 ibid
530 Vieten at p 166
531 ibid
532 ibid
533 Section 26 (1) KWG

reports to regulatory authorities, as well as auditors' reports which focus on capital ratios and other items have become important focal points.[534] Auditing provides a vital connection between prudential authorities and regulated financial institutions.[535]

Under the Bank of England's regime, British banking law featured just a few reporting requirements.[536] The audit report still follows company law by stating whether or not the financial statements provide a true and fair view and are properly in accordance with the Companies Act 1985. The regime of its successor, the Financial Services Authority, has led to a more reduced level of frequency in number of reports produced. From 1 April 2003 to 31 March 2004, the FSA exercised its power under section 166 of the Financial Services and Markets Act 2000 to require firms to produce a skilled person's report in 28 situations.[537] This is a considerable reduction in investigations from the number of reporting accountants commissioned under section 39 Banking Act 1987 which frequently exceeded 600 reports annually.[538]

Under Statement of Auditing Standards (SAS) 620 Revised: The Auditor's Right and Duty To Report To Regulators in the Financial Sector, auditors have routine reporting responsibilities and also responsibilities to provide a special report required by the regulator. In addition, auditors are required by law to report, subject to compliance with legislation relating to "tipping-off", direct to a regulator when they conclude that there is reasonable cause to believe that a matter is or may be of material significance to the regulator.

In the UK, prior to 1994, there was only a right to report under section 47 of the Banking Act 1987.[539] This gave the auditor the right to report any matters of prudential concern to the Bank of England. Usually auditors are under a duty not to communicate with third parties. However, as long as the auditor had communicated to the regulator in good faith, he could not be considered to have breached any duty of confidentiality. SAS 620 gave rise to an extension of the right to the duty to communicate.[540] In Germany, however, there has always been strict rules upon the auditor in that he had a duty to communicate.[541] There is still no statutory duty to communicate in the UK even

534 Vieten at p 166
535 ibid
536 See Vieten p 167
537 P Dewing and P O Russell at p 107
538 ibid
539 See Vieten p 168
540 ibid
541 ibid

though the duty to report has gone beyond just using a professional standard (SAS 620) to using a statutory instrument.[542] Apart from the duty to report to regulators in the financial sector, the auditor can also provide reports as a skilled person.

In the UK, section 166 of the Financial Services and Markets Act 2000 deals with the powers of the FSA to obtain a report by a skilled person (reporting accountant) to assist the FSA in performing its functions under FSMA 2000. Under sections 167 and 168 of the Financial Services and Markets Act 2000, the FSA also has the powers to appoint competent persons to carry out investigations. The differences between the roles of reporting accountants (now known as skilled persons) and competent persons are demonstrated by the bearer of the costs for work carried out by these persons. For work undertaken by skilled persons, the bank bears the cost directly whilst for work undertaken by competent persons, the FSA bears the cost.[543] The role of the reporting accountant has become so important that it will be incorporated into the entire regulated sector.[544] Even though skilled persons are usually approved by the FSA, the role is usually performed by auditors of the regulated firm.[545] This raises the question of independence since both roles of auditor and reporting accountant are distinct roles which still overlap occasionally.[546] Measures have however been adopted by the FSA to safeguard against possibilities of a conflict of interest. Chapter 5 of the FSA Supervision Manual provides examples of circumstances where the FSA may use skilled persons. The FSA may nominate or approve the appointment of the auditor of a bank as a skilled person if it is cost effective to do so but also takes into account any conflicts the auditor may have in relation to the matter to be reported on. There are also defined and limited circumstances in which a firm can use skilled persons.[547]

The Federal Financial Supervisory Authority has the powers to carry out special audits at any time but also makes use of external firms of certified accountants or could ask the *Bundesbank* for help. The *Bundesbank* audits minimum reserves and foreign currency transactions and parts of the audit

542 See paragraph 3 of the Accountants (Banking Act 1987) Regulations 1994, SI 1994/524

543 See J Hitchins, MHogg and D Mallett, *Banking: A Regulatory Accounting and Auditing Guide* (Institute of Chartered Accountants 2001) 295

544 D Singh, 'The Role of Third Parties in Banking Regulation and Supervision' (2003) 4 (3) Journal of International Banking Regulation 9

545 ibid

546 ibid

547 According to chapter 5 of the Supervision Manual, the FSA stated that firms are to appoint skilled persons only for specific purposes; not to use them as a matter of routine; to use skilled persons only after having considered alternatives; to use skilled persons because of the added value to be gained due to their expertise or knowledge and not because of resource restraints; to take into account cost implications and to use the tool in a focused and proportionate way.

are performed for the Federal Financial Supervisory Authority.[548] The *Bundesbank* does not charge any fees and there is a limit to the number of audits it can undertake for the Federal Financial Supervisory Authority.[549] For all other audits carried out by external auditors, which are section 44 reports, the external auditors are paid by the banks.[550]

Whilst the Bank of England usually used a financial institution's chosen auditor (even though it had the power to appoint its chosen auditors), the Federal Financial Supervisory Authority might select a different firm of accountants.[551]

The FSA may nominate or approve the appointment of the auditor of a bank as a skilled person if it is cost effective to do so but also takes into account any conflicts the auditor may have in relation to the matter to be reported on. There are also defined and limited circumstances in which a firm can use skilled persons.[552] There are certain advantages in using a financial institution's chosen auditor in that the auditor will most likely have worked at the bank before and therefore be familiar with the environment. This will save costs as he is not learning new things about the bank and is more familiar with vital information and procedures required for the audit. However, audit firms need to be rotated and if the same audit firm had been used by the bank for quite some time, this may affect the judgment of the audit firm as to much familiarity with the client (bank) could compromise the objectivity and independence of the audit firm. As a result of potential conflicts of interests, it may be said that the FSA's approach is definitely an improvement on the approach previously taken by its predecessor.

Whilst the FSA's use of external auditors has declined, when compared to the use of external auditors by the Bank of England, it may be justified based on its reduction in use of external auditors also acting in the dual capacity of skilled persons. Where the external auditor acts solely and exclusively as an external auditor, and not under the dual role of skilled person/auditor, then increased use should be made of such auditors.

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548 See Vieten p 169
549 ibid
550 ibid
551 Ibid at p 170
552 According to chapter 5 of the Supervision Manual, the FSA stated that firms are to appoint skilled persons only for specific purposes; not to use them as a matter of routine;to use skilled persons only after having considered alternatives; to use skilled persons because of the added value to be gained due to their expertise or knowledge and not because of resource restraints; to take into account cost implications and to use the tool in a focused and proportionate way.

The Impact of the Eighth EU Council Directive on German and UK Auditing Professions All UK registered companies are subject to an annual external audit as part of the requirement of the Companies Act of 1985.[553] As from July 2000, companies meeting two tests of the Audit Exemption Amendment 2000 SI 2000/1430 and also requirements of the EC Fourth Directive were exempted from the audit requirement.[554] Through the Companies Act 1989, regulatory authority for auditing was given to the Secretary of State but the accountancy profession still maintained its self-regulatory status through the major professional bodies assuming the title of Recognised Supervisory Bodies whereby the Secretary of State could still delegate power through them.[555] The implementation of the Eighth Directive through the Companies Act of 1989, addressed auditor independence in two ways namely:[556] Firstly by stating the ineligibility of a person to be appointed as auditor where he is an officer or employee of that company or a partner/employee of a company officer or employee[557] and secondly, by requiring Recognised Supervisory Bodies to have rules on eligibility as a further measure[558].

As a result of their historical development, large German audit firms were often owned by banks or the State.[559] Article 2 of the 8th Directive allows an exemption with respect to voting rights and if this exemption had not been implemented in Article 2, these owners (banks and the State) would have been barred with the resulting violation of the German constitution and legal proceedings against the State.[560]

The UK implementation the 8th Directive through the Companies Act 1989 resulted in more rules being laid down in legislation instead of being delegated to the accounting profession.[561] More importantly, there was the removal of the prohibition for auditors to incorporate with effect from 1 October 1991.[562] KPMG expressed their views on incorporation – their objection having been based

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553 See JE Stevenson, 'Auditor Independence : A Comparative Descriptive Study of the UK, France and Italy p 161

554 Ibid; the tests under the Audit Exemption being turnover up to £1 million and/or balance sheet total up to £1.4 million and/or maximum of 50 employees. The Secretary of State for Trade and Industry raised the turnover requirement to the maximum of £4.8 permitted under the Fourth Directive.

555 ibid

556 Ibid p 162

557 Section 27(1)

558 Schedule 11

559 L Evans and C Nobes, 'Harmonisation of the Structure of Audit Firms : Incorporation in the UK and Germany' The European Accounting Review131

560 Ibid pp 130,131

561 Ibid p 135

562 ibid

rather on concerns related to auditor independence and confidentiality with the most apparent problem being the audit client holding shares in the audit firm.[563] KPMG did not object in principle to the idea of incorporation but rather to the idea of outside shareholders as they felt that the same person should not be allowed to hold a directorship with the auditor and his client.[564]

7.15.5.Safeguards to Independence in Germany

Germany on the other hand in 1985, introduced a law requiring all new corporate auditors to be wholly owned by persons working in the business of the corporate auditor and with a majority of voting shares being held by qualifying interests.[565] In so doing, Germany was taking measures to strengthen independence.[566] German audit reforms which became law in April 1998 have made it compulsory for auditors to modify audit reports and disclose through a middle paragraph, a going concern limitation, a disclosure omission or non compliance with generally accepted accounting principles.[567] According to the German Stock Corporation Act, it is compulsory for all German stock corporations to have a supervisory board (Aufsichtsrat) and a management board (Vorstand).[568] Before the 1998 audit reforms, no guidelines were in place as regards who was responsible for hiring the auditor.[569] Management was usually responsible for the hiring of auditors whilst the supervisory board approved the appointment and since the auditor was hired to check up on management's compliance with laws and safe-guarding of assets, there were apparent conflicts of interest in the auditor's appointment before the 1998 audit reforms.[570] As well as making the supervisory board responsible for hiring the auditor, the audit reforms made it mandatory for the auditor to report exclusively to the supervisory board.[571] The reforms brought about an increase in the legal liability limits for auditors which resulted in additional incentives for auditors to act independently by detecting and reporting accounting omissions, irregularities and uncertainties.[572]

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563 Ibid p 134
564 ibid
565 ibid
566 ibid
567 HA Skaife and J Gassen, 'Can Audit Reforms Change the Monitoring Role of Audits? August 2006
568 ibid
569 ibid
570 ibid
571 Ibid; The auditor now also has to submit the long-form audit report and a set of financial statements to every supervisory board member, attend meetings of the supervisory board. The reforms brought into force legislation which stipulated that the long-form audit report had to be written in a precise and understandable manner – such as would be clear to a lay man or non-expert whilst maintaining its confidentiality.
572 ibid

7.15.6Safeguards in the UK

UK legislation implements only the minimum requirement of Article 2 which requires a firm of auditors to be controlled by qualified persons (where this is defined mainly with respect to voting rights).[573] The Institutes (ICAEW, ICAS and ICAI) considered this as insufficient to safeguard auditor independence if control meant that only a mere majority of voting rights.[574] Using their position as Recognised Supervisory Bodies, they put in place a requirement that at least 75% of voting rights should be held by qualified auditors – which also applies to voting rights on the management body.[575]

7.15.7 Convergence

As mentioned previously, the UK is moving towards the German system in terms of relying more on state regulation.[576] In other areas however, there have been problems with harmonisation. The Green Paper highlighted the weaknesses of the Eighth Directive in failing to produce a common definition of independence – thereby resulting not only in an incomplete regulatory framework but also one which was not helping to fulfil EC objectives.[577]

European harmonisation would help place the European Community in a strong position to take on an international role with bodies such as the International Accounting Standards Committee (IASC) and the International Organisation of Securities Commissions (IOSCO).[578]

Following the Green Paper proposals, a new Committee on Auditing was established by the European Commission which consisted not only of representatives from auditing regulators in the 15 Member States and 3 countries of the European Economic Area (EEA), but also of representatives from the audit profession, internal auditors and large European firms.[579] This signified a new approach to regulation by the European Commission in that unlike the previous use of directives to harmonise, the European profession was called upon to draft a common set of principles as a starting point.[580] Given the problems of harmonisation with the Eighth Directive, the

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573 L Evans and C Nobes, 'Harmonisation of the Structure of Audit Firms: Incorporation in the UK and Germany' The European Accounting Review 137

574 ibid

575 ibid

576 Vieten 1997 p 155

577 J Stevenson, 'Auditor Independence : A Comparative Descriptive Study of the UK, France and Italy' International Journal of Auditing 156

578 Ibid p 156

579 ibid

580 ibid

Green Paper had to avoid regulating at EU level and the draft of a set of common principles by the European profession (FEE) made this possible.[581] The FEE's efforts resulted to the 1998 publication of "Statutory Audit – Independence and Objectivity, Common Core Principles for the Guidance of the European Profession" (Initial Recommendations) and this publication has provided the framework for the European Commission Consultative Paper "Statutory Auditors' Independence in the EU : A Set of Fundamental Principles" issued in 2000.[582]

The Recommendation issued by the European Commission Statutory Auditor's Independence in the EU: A Set of Fundamental Principles on 16 May 2002, does not require mandatory rotation of firms but does require mandatory partner rotation on listed clients after seven years.[583] This differs in some aspects from the UK requirements as: [584] (i) It allows a return after two years (not five years as in the UK); (ii) It applies to 'public interest clients' not just listed clients and (iii) In a group context, it extends to key audit partners other than the audit engagement partner. No country within the EU, with the exception of Italy presently undertake a system of mandatory audit firm rotation.[585]

If this recommendation fails to achieve desired harmonisation, the European Commission intends to resort to the use of legislation.[586] The process of European Union auditing harmonization has so far, been successful and is likely to continue to be so in the future.[587] Convergence with International Accounting Standards requires constant and thorough enforcement procedures across Europe and around the world.588 The UK's Financial Reporting Review Panel (FRRP) is considered by the FEE as a potential model for other EU jurisdictions even though some have commented that the effectiveness of the FRRP could be further strengthened by introducing some form of pro-active monitoring.[589] It was however added that any changes to the FRRP should be co-ordinated with developments in Europe.[590]

A survey carried out by the FEE shows that the principles-based approach to auditor independence

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581 ibid
582 ibid
583 S Fearnley, 'Mandatory Rotation of Audit Firms' p 9 ; see <http:// www.icaew.co.uk/publicass>
584 ibid
585 ibid
586 J Stevenson, 'Auditor Independence : A Comparative Descriptive Study of the UK, France and Italy' International Journal of Auditing 156
587 J Stevenson, 'Auditor Independence : A Comparative Descriptive Study of the UK, France and Italy' International Journal of Auditing 161
588 See 'Enforcement of Standards' <http://www.law.unimelb.edu.au/cclsr/policy_new/news/ukparliament.pdf>
589 ibid
590 ibid

which is set out in the EU Recommendation on Independence is now extensively used throughout Europe.[591] The importance of a regulatory pause has been highlighted to allow time for this approach to auditor independence prove its worth to users of audit reports.[592] Both the EC Recommendation and the Code of Ethics of IFAC (International Federation of Accountants) adopt a conceptual framework approach to independence . The Recommendation makes it necessary for auditors to identify, consider and document potential threats to their independence and to detail safeguards which have been put in place to eliminate those threats.[593]

7.15.8Comparisons between the UK and Italy

7.15.8.1 First Investigative Aim:

Even though Italy is still in the process of adopting its single regulator for financial services, the importance of the central bank's role in the supervisory process is emphasised. Indeed, the Bank of Italy's powers are so immense that efforts are being made to curtail it – in contrast to the position of the Bank of England. This goes to show that even though the central bank's involvement in the supervisory process is of immense importance, its powers should not be so great that this results to lack of accountability in the financial process. Lessons from Parmalat and the failure of the Bank of Italy to intervene when it should led to rapid reforms being made to curtail the Bank of Italy's powers and catapulted the process of the adoption of a single regulator. Whilst the central bank's role in supervision is of immense importance, a balance should be struck between those powers assigned to it and those powers assigned to the supervisory agency.

7.15.8.2 Second Investigative Aim:

There is more focus on meta-risk regulation (the adoption of the Basel II Accord) by the Bank of Italy than on risk based supervision when compared to the UK.

7.15.8.3 Third Investigative Aim

The concept of the external audit has not been in operation in Italy for a considerably long period – however, it has been distinguished from the traditional *sindaci* (internal) audit through legislative restraints on the role of the *societa di revisione* and equipping the stock exchange authority with

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591 See <http://www.fee.be/publications/default.asp?library_ref=4&content_ref=552> (last visited 17th Feb 2007)

592 ibid

593 See < http://www.fee.be/fileupload/upload/PR46.Implementing%20EC%20Recomm%20on%20Independ.Final1822005531252.pdf> last visited 17th Feb 2007)

primary control over external listed audits.[594] The Italian guidance is surely not as developed as that in the UK – due to it being more recent, however **most of the safeguards in Italy are laid down in legislation or under stock exchange control.**[595] As a result, not only is there stronger statutory control and uniformity in Italy than the UK, there is also stronger power distance and uncertainty avoidance in comparison to the weak power distance and uncertainty avoidance which exists in the UK.[596] The role of CONSOB in regulating external audit of listed companies and its participation- being a stock market regulator, appears to be provide tighter measures for ensuring that auditors perform their duties in an objective manner and are seen to do so.[597]

The issue is that in Italy, 98% of the companies are of small/medium size, do not depend on the stock market, and as a result, rely on banks or government and/or EU grants for financial resources. Financial institutions are more dependent on other resources and sources of financial information than a set of fiscally biased financial statements information.

7.15.9Comparisons between the UK and the US

7.15.9.1 First Investigative Aim

In contrast to the UK, the US has not adopted a single regulator even though it realises the need to do so. Historical factors and the complex structure of regulation which exists in the US would undoubtedly make it difficult to overhaul the present system of regulation. Such is the complexity of the present system of regulation that issues relating to responsibilities of various regulators in the event of an adoption of a single regulator, need to be carefully considered. If jurisdictions with just one supervisory authority still experience problems in allocating supervisory responsibilities, the task for the US system of supervision would not be less difficult.

7.15.9.2 Second Investigative Aim

The significance of the US risk based approach to supervision is that it focusses on the firm's risk management techniques and the safety and soundness of the bank whilst the UK seeks to focus on a specific interpretation of risk which connects risk and risk taking to objectives and principles.[598] The UK and US however have adopted similar approaches as they both try to manage regulatory

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[594] J Stevenson, 'Auditor Independence: A Comparative Descriptive Study of the UK, France and Italy' International Journal of Auditing 176

[595] ibid

[596] ibid

[597] Ibid p 177

[598] D Singh, 'Legal Aspects of Prudential Supervision' 2007 p 134

resources according to the risks posed by the respective institutions. Both systems are also similar in that they both emphasise the importance of being able to oversee the business undertaken by a group and an individual bank to assess whether such group activities present risks to objectives.[599] Categories used in UK and US risk assessments are also similar even though they are labelled differently.[600]

Work undertaken by the OCC, in comparison to the UK's FSA, does not show provision for cross comparisons with other banks in a sector and the different risk based systems in the US banking sector would make cross sector comparisons difficult.[601]

7.15.9.3 Third Investigative Aim

Following the Enron debacle, concerns were raised about the UK's financial reporting system and as a result of greater awareness to continuously develop the financial reporting system and standards, there has been greater effort to improve accounting practices of UK listed companies – particularly at international level.[602] In response to a move aimed at facilitating integrated financial services market in the EU, a draft regulation was published in February 2001 in the aftermath of an announcement by the European Commission in June 2000 that it would be mandatory for EU listed companies to use International Accounting Standards (IAS) in their consolidated accounts from 2005.[603] In March 2002, the European Parliament gave approval for adoption of standards issued by the International Accounting Standards Board (IASB) which governs listed companies when preparing financial statements.[604]

Problems within the UK corporate reporting sector include limited statutory requirements and non mandatory Accounting Standards Board (ASB) guidance on the operating and financial reviews of listed companies.[605] Since the late 1980s, continual efforts have been made in the UK to reduce the potential for exclusion of assets and liabilities from the balance sheet – particularly those which could affect the overall standing of companies.[606] The development of US standards has not attained

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599 ibid
600 ibid
601 ibid
602 See <http://www.law.unimelb.edu.au/cclsr/policy_new/news/ukparliament.pdf>
603 ibid
604 ibid
605 See House of Commons Treasury Minutes of Evidence pp 4 and 5 of 23 <http://www.law.unimelb.edu.au/cclsr/policy_new/news/ukparliament.pdf>
606 ibid

this level although the FASB is considering moves in such direction.[607] Although the Enron affair has not revealed any significant issues which present great concern for UK financial reporting standards, there is constantly a need to develop standards to incorporate new business practices, reasonable shareholder expectations and other developments.[608]

Differences in audit regulation between the UK and the US comprise the following:[609] There exists a principles-based approach system in the UK as opposed to a rules-based system which exists in the US; in the UK, the inspection regime is controlled by full-time professionally qualified inspectors employed by the professional bodies and whose work is approved by the government.; the UK Accountancy Foundation supervises the profession's regulatory and disciplinary arrangements to ensure they are in accord with public interest.

Examples of safeguards adopted in the UK to protect the independence of auditors include:[610] The ability of staff on audit assignments to communicate concerns to a separate partner Provision for an independent partner to be reviewer or reviser of the work Regular rotation of audit partners

Effective interchange between the audit committee and auditor

Segregation of responsibilities and knowledge within the audit firm.

Existing provisions to protect the auditor's independence in the event of providing non-audit services include:[611] The prohibition by the Institute of non-audit services to audit clients where that would present a threat to independence for which no safeguards are available; secondly, the audit committee, as representative of the shareholders has the responsibility of overseeing the relationship with the auditor, checking that the nature and scope of non-audit services in operation and satisfying itself that the auditor's independence and objectivity are not compromised; thirdly, the ethical code states that an audit appointment to a listed company should not be accepted where the client provides as much as 10% of a firm's gross income; and fourthly, an improved environment facilitating transparency has been created over the years whereby shareholders themselves are able to gauge the extent of non-audit services provided by auditors.

607 ibid
608 Ibid p 5
609 Ibid p 13 of 23
610 Ibid p 11 of 23 (last visited February 5 2007)
611 Ibid p 15 of 25

Arguments in favour of the provision of non-audit services include the need for auditors to be able to acquire knowledge and experience from colleagues who are experts in key risk areas.[612] In addition, rigid separation of audit and non-audit services within such a firm would lead to a decrease in the level of audit quality, an increase in cost or some combination of both.[613] In addition, the chairman of the SEC expressed his view that creating an "audit only" firm would not necessarily guarantee an "audit failure free" future.[614] This is true, however any reduction in audits failures (be it not 100%), may range from little to a highly significant reduction – significant enough to avoid a major corporate crisis.

Arguments in favour of mandatory rotation of audit firms require the consideration of two issues namely whether there is a link between the length of association and reduction of audit quality, and whether mandatory rotation in principle, would result to increased audit quality.[615] In the United Kingdom, legislation requires shareholders to appoint auditors annually and the Combined Code requires audit committees to keep under constant review the independence of the auditor[616]. According to opponents of mandatory rotation, these provide a better safeguard than fixed-period mandatory rotation.

7.16 ASSESSMENTS

Even though Germany's system of supervision is advantageous in that its central bank, the *Bundesbank*, has principal functions within the regulatory and supervisory process, it has not amended its substantive law and cannot be said to be exploiting maximum possible benefits of implementing a single financial services regulator. This is in contrast to the UK, whose legislation was amended following the adoption of a single financial services regulator. The Financial Services and Markets Act 2000 has gone a long way in improving accountability within the financial services sector.

However it has also been argued the FSA is not sufficiently accountable to Parliament and to those financial customers on behalf of whom it regulates the financial services sector and who indirectly

612 Ibid p 16
613 ibid
614 ibid
615 Ibid p 17
616 Ibid p 18

pay for its costs through charges imposed.[617] Apart from recommending that the composition of the FSA Board be changed, that members of the FSA's Consumer Panel should not all be appointed by the FSA and that the Financial Ombudsman Service[618] be made into an entirely separate statutory organisation from the FSA, it has also been noted that the Financial Services and Markets Act 2000 protects the FSA and its staff from being held liable to policyholders for losses arising from its negligence.[619] This is in contrast to the situation which exists in Germany , Italy where the supreme courts of these jurisdictions have held that banking regulators can be held liable for loss caused to depositors as a result of their negligence.[620]

Even though the introduction of new UK legislation (and its approach to integrated supervision as a result), has its benefits, the UK's system of supervision since the adoption of a single regulator also has its disadvantages. The UK's adoption of a risk based approach to supervision by its regulator, the FSA, has led to the reduction of the use of external auditors by the FSA. The risk based approach to supervision is to be commended and if it were carried out on a sectoral level, that is, within the different sectors (insurance, banking sectors) as opposed to an integrated level, more resources could be allocated to the banking sector than is the case at present. This could be achieved by allocating a stipulated amount of resources to each sector rather than the present system whereby more resources are dedicated to the insurance sector. A risk based approach to supervision could then be carried out within the different sectors. For example, within the banking sector, priority would be given to external auditors, such that the number of external auditors used for on-site inspections in particular, would be increased to a level above that which had ever operated.

This is important, not only because the Basel Committee for Banking Supervision recommends the

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617 Summary of Submission to the House of Lords Select Committee on the Accountability of the Financial Services Authority in general, and of the Accountability of the Government and of the Parliamentary Ombudsman Regarding the Equitable Debacle.

618 The Financial Ombudsman Services was established under the FSMA 2000 in order to facilitate quick resolution of disputes between consumers and financial service firms. It is a company limited by guarantee, without share capital, deals with approximately 108,000 cases annually and has an estimated budget of about £53.1 million. Whilst the Financial Ombudsman Service is an independent arbitration service, and whilst the Financial Ombudsman Service Board is responsible for appointing the Chief Ombudsman and ensuring his independence, the FSA is responsible for appointing members of the Financial Ombudsman Service Board, for establishing the scheme's scope and areas of functions, and for establishing principles for handling customer complaints. For more information on this, see 'Sir Christopher Kelly appointed chairman of the Financial Ombudsman Service ' <http://www.fsa.gov.uk/Pages/Library/Communication/PR/2005/008.shtml (last visited 12th February 2007)

619 Summary of Submission to the House of Lords Select Committee on the Accountability of the Financial Services Authority in general, and of the Accountability of the Government and of the Parliamentary Ombudsman Regarding the Equitable Debacle.

620 ibid

use of external auditors, but because the reduced involvement of the Bank of England in the bank supervisory process warrants greater use of the expertise which could be provided by external auditors. In addition, a more pro active approach (increased use of on-site inspections) to bank supervision was suggested following the collapse of Barings Bank. External auditors can help bank examination staff perform on-site inspections.

Risk based regulation has also impacted the UK's financial enforcement procedures as demonstrated by the *Legal and General Assurance Society (L & G) v FSA* case[621]. This case has also brought to light the need for a more proactive approach to bank supervision. Self-enforcement, monitoring by regulators, the approval of financial statements and the statutory audit are enforcement mechanisms used by the UK, Germany and Italy. There are large differences in legal environments and these contribute in part to the differences in the enforcement procedures.

In determining whether a particular jurisdiction's accounting system and auditing practices are better than the other, factors such as jurisdictional differences, objectives and main purposes of each individual jurisdiction's financial reporting systems need to be taken into account. For example, in comparing US and German accounting/auditing, one may assume right from the outset that US accounting is better because there is more disclosure.[622] However, US accounting is very expensive to operate and such costs may not be justifiable for a country like Germany where there are limited capital markets.[623] US financial reporting also produces more volatile series of earning figures than German accounting and even though this may be beneficial to active stock market users, it may not be so for a longer term view – a position which is usually favoured by German financiers.[624]

The different mix of users in the various countries also need to be considered. In Germany for instance, the importance of banks has been given as a possible reason for greater conservatism in reporting than in the UK.[625] Conservatism is however becoming a thing of the past in Germany and many European jurisdictions like Italy as many listed companies adopt IAS or US rules.

In addition, to the categories of threat mentioned under the introductory section of this chapter, notable and key threats to auditor independence include:

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621 In this case, the FSA relied on too small a representative sample

622 C Nobes and R Parker, *Comparative International Accounting* 569

623 ibid

624 ibid

625 Ibid p 36

7.16.1 The Provision of Other Services to Audit Clients

Out of all the issues revolving round independence of auditors, this is the most debatable. The UK's position on this issue shows no objection to a firm providing advisory services to a company which are additional to the audit.[626] The UK 1989 Companies Act required disclosure of audit and non-audit fees paid to audit firms to be disclosed separately in financial statements – the aim of this being to provide information to investors which would help judge the relationship between the company and its auditors.[627] In Germany, non audit services are also allowed, except for book-keeping.[628] In Italy, the legal and professional bodies regard the provision of additional services by statutory auditors as a significant threat to their independence.[629] In Italy, Presidential Decree 31.3.75 no 136 addresses the issue of members who are external auditors and forbids them from having other contractual relationships with the audit and from offering additional paid services to the client.[630]

7.16.2 Acting For the Same Audit Client for a Prolonged Period of Time

The UK Companies Act section 385(2) requires annual appointment of statutory auditors.[631] Italy appoints its statutory auditors for more than one year and since these are statutory requirements, there is no ethical guidance on this matter.[632] Germany on the other hand, has no fixed term and like the UK, the length of mandate is usually for one year.[633] Auditors in Italy could be said to be in a stronger position relative to their counterparts in the UK and Germany when faced with client pressure.634

7.16.3 Rotation of the Engagement Partnership

The position in the UK can be differentiated from that in Italy since UK firms are allowed to keep their clients as rotation applies only to engagement partners.[635] In Germany, rotation of the

626 J Stevenson, 'Auditor Independence : A Comparative Descriptive Study of the UK, France and Italy' International Journal of Auditing 169

627 Ibid p 170

628 C Piot, 'Auditor Reputation and Model of Governance' International Journal of Auditing Volume 9(1) 2005 26

629 J Stevenson, 'Auditor Independence : A Comparative Descriptive Study of the UK, France and Italy' International Journal of Auditing 172

630 Ibid p 171

631 Ibid p 172

632 ibid

633 C Piot, 'Auditor Reputation and Model of Governance' (2005) 9 (1) International Journal of Auditing 26

634 J Stevenson 'Auditor Independence : A Comparative Descriptive Study of the UK, France and Italy' International Journal of Auditing 172

635 Ibid p 173

engagement partner takes place every 6 years.[636]

The safeguards implemented in such jurisdictions such as Italy (prohibition of provision of non audit services by audit firms), Germany (prohibition of provision of book keeping services by audit firms), could be considered in the UK. The benefits of allowing the provision of non audit services by audit firms, namely the need for auditors to gain knowledge and experience from other colleagues, increase in level of audit quality, should be weighed against the risks to be encountered if an audit firm's independence is compromised as a result of provision of non audit services.

Given the present operating UK safeguards, to protect the auditor's independence in the event of providing non audit services, this does not seem to be an area which warrants great cause for concern.

Questions regarding change to the UK's system of audit regulation especially following the collapse of Enron necessitate not only consideration of reasons for changes arising from the major corporate collapses which occurred in the late 1980s and early 1990s in the UK (and which resulted to many differences between the UK and US systems of audit regulation), but also require consideration of existing safeguards currently in place in the UK to protect the auditor's independence.

Accounting standards are more detailed and powerful in the US than in the EU – as a result, there is greater uniformity of practice than in any other country.[637] It would be easier to implement enforcement procedures and provide more effective monitoring where there was greater uniformity. As mentioned previously, the harmonisation process in the EU has encountered various difficulties but it can be said that more uniformity has been achieved since the early 1980s when the EU's harmonisation efforts began.[638]

7.17 Conclusion

7.17.1 First Investigative Aim

It is of vital importance that countries address two fundamental questions where reorganisation of their financial regulatory structure is being considered namely: Whether some model of unified financial services supervision be followed; and if unified financial services supervision were to be

636 C Piot, 'Auditor Reputation and Model of Governance' (2005) 9 (1) International Journal of Auditing 26
637 Nobes and Parker p 46
638 Ibid p 44

adopted, how it should be done.[639] These questions should be addressed having regards to the countries' historical, economic, institutional and political frameworks.[640]

In considering particularly, the *Bundesbank*'s approach to supervision and its use of external auditors, this chapter has not only shown how the FSA can use external auditors in the supervision process, but also how other regulators in the investigated jurisdictions can benefit from the involvement of external auditors in the supervision process. Benefits of the central bank's involvement in banking supervision in jurisdictions such as Germany, Italy and the US have also been considered. The degree of the central bank's involvement in the supervisory process is also an important factor which is worth consideration. Whilst it is concluded that countries such as the UK would benefit from greater involvement of the central bank, the dangers of the central bank having too much powers is demonstrated in the case of the Bank of Italy. Following the collapse of Parmalat, the Bank of Italy's powers have been curtailed. The Italian financial regulatory framework went through a major overhaul in 2005 through the Law 262 of December 12th 2005 on Protection of Savings and Financial Markets Discipline. CONSOB, the securities market watch dog was to have additional powers resulting in the new CONSOB being more powerful than its predecessor and taking over the supervision of debt issuance from the Bank of Italy.[641] CONSOB's powers have been re-inforced in many ways including:[642] Additional investigative powers; the capacity to directly apply sanctions; a new internal framework.

In the UK, external auditors could help provide some solutions to the gap left as a result of the Bank of England's reduced involvement in the banking supervisory process. Auditors have valuable and vital third party knowledge of firms and the FSA would benefit immensely by exploiting such priceless expertise and knowledge. The FSA places great reliance on the cooperation of regulated firms to provide information which is timely, accurate and complete in order to be able to gauge whether a firm is complying with its requirements. Auditors can help facilitate smooth functioning of the supervisory process as they are also required under the FSMA to inform the FSA of certain matters of concern and have to provide annual reports to the FSA. The FSA in its proximity to the market and consumers would also need to be mindful of not getting 'captured' by those it is

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[639] K Mwenda and A Fleming, 'International Developments in the Organizational Structure of Financial Services Supervision' [2001] 6

[640] Ibid p 7

[641] 'Italian Financial Regulation : Not So Super Consob; The Economist Feb 5th 2004

[642] See M Moriconi, ' Italy : Changes to the Legislative and Regulatory Framework post-Parmalat – Some Faster than Others!' Hill and Knowlton's Financial Services Newsletter Number 5 May 2005

supposed to be regulating.

There is no formal statutory based relationship between the supervisors and external auditors in countries such as the USA and Italy.[643] Supervisors in these countries depend on direct inspections which they themselves carry out and commercial law governs the appointment of bank auditors.[644] In the UK and Germany, the banking supervisor has statutory powers over the appointment of external auditors, such as the right of approval or removal, and the right to commission an independent audit.[645] These powers help banks in ensuring that external auditors with the required experience, resources and skills are appointed to perform their duties.[646] The bank supervisor's statutory powers also help avoid the situation which occurred in Legal and General in that it encourages the use supervisor to engage more in pro active supervision. In contrast to the Bank of England which commissioned reporting accountants' reports on annual and routine basis, the FSA predominantly uses its own front line supervisors in carrying out risk assessments. As a result, a more proactive approach to supervision, such as that which exists in Italy[647] and the US is encouraged and not just a proactive approach, but one which involves greater use of external auditors.

7.17.2 Second Investigative Aim

The immense contribution made by external auditors to the supervisory process is demonstrated in association with the implementation of Basel II. They can contribute towards the process of certifying more advanced model-based approaches to measuring credit, market and operational risks and verifying information required for disclosure under Pillar 3 of the Basel II Accord[648].

As seen from the analysis on the US, there is great interest in the implementation of Basel II. The US realises that it needs a regulatory framework which corresponds to changes in global events. In

643 E Huepkes, 'The External Auditor and the Bank Supervisor' p 10 ; Italy has a statutory auditor though

644 ibid

645 ibid; See German Banking Act section 28; FSMA 2000 section 166

646 ibid

647 In order to ensure proper compliance with the Bank of Italy's regulations, inspections are performed by the central and district inspection departments. These inspections are distinguished as either periodic or extraordinary. Periodic inspections are carried out without prior notification whilst extraordinary inspections are performed whenever irregularities are highlighted at a bank. Periodic inspections usually occur at the head offices of the banks and/or at the main branches and are classified as general where each aspect of bank activity is examined. The bank's management and operations are reviewed as required by the Bank of Italy and on conclusion, a report is written. Extraordinary inspections can be either general or sectoral and are amongst the most important tools for the Bank of Italy to identify and resolve irregularities. The Bank's inspectors have the right to examine any documents and obtain relevant other information during the inspections. See pp 232, 233 , Business Law Guide to Italy

648 E Huepkes, 'The External Auditor and the Bank Supervisor' p 11

the face of globalisation and conglomeration, the risks posed by financial institutions call for better management techniques. As it has retained its regulatory structure, the US realises that other measures need to be adopted to manage cross sector service risks which can be managed more efficiently by a single regulator. This is probably the reason for the great interest shown by the US in a meta-risk based model such as that of Basel II.

External auditors can therefore play an important role not only in risk based regulation, but also in the Basel II process. They can assist in the validation process of the advanced techniques used for measurements under the Basel II Accord.[649] In addition to this role, external auditors can also help the regulator in the process of obtaining information which the regulator needs to assess whether a regulated institution is complying with required standards.

7.17.3 Third Investigative Aim

Other benefits of using the external auditor in the bank regulation and supervisory process include the ability of the external auditor to provide a wide range of resources and knowledge and acting as an intermediary for the regulator, thereby helping to protect the regulator's reputation and avoiding regulatory capture. The risks involved in using the external auditor include conflict of interests[650], loss of information during the transfer of information to the regulator and higher costs.[651]

It is appropriate to use external auditors as 'indirect supervisors' in the supervisory process even where such risks of conflict may exist - provided there are safeguards to protect against such risks. However external auditors used in this way should not also be protected by the immunity that shields regulators from tort of negligence actions. In comparison with various European jurisdictions, the US legal system is said to be unique as a result of the ease with which large class lawsuits can be instigated at relatively low cost.[652] This results from a public view of protection for individuals who have been harmed.[653] There are however similarities between the US and the UK in that legal responsibilities to third parties in these jurisdictions are similar.[654] Whether auditors in the UK should be afforded limited audit liability is however another issue – given that no statutory

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[649] ibid

[650] The external auditor in this situation would not only owe obligations to the bank, its shareholders but also to the regulator and those investors whose interests are being safeguarded by the regulator.

[651] E Huepkes, 'The External Auditor and the Bank Supervisor' p 12

[652] B Anderson, M Maletta and A Wright, 'Perceptions of Auditor Responsibility: Views of the Judiciary and the Profession' (1998) 2 (3)International Journal of Auditing 229

[653] ibid

[654] ibid

duty is owed by an auditor to an individual third party. Whilst protection measures exist for aggrieved individuals in the US in that large class lawsuits can be instigated at relatively low cost, such ease of initiation does not exist in the UK.

Factors such as culture and historical development have played defining roles in shaping the audit approaches adopted in Germany, Italy, the US and the UK. These jurisdictions represent a reasonably diverse selection with Gray[655] classifying Italy as a country whose accounting system in terms of authority and enforcement, exhibited strong uniformity and weaker professionalism. The UK's accounting system was considered to show strong flexibility and professionalism.[656] In terms of measurement and disclosure of accounting systems, the Italian system (like the French), is considered strongly conservative than the more transparent UK system.[657]

7.17.4 Harmonisation Efforts and Difficulties

The requirement of the EU's Fourth Directive that "true and fair" should take precedence over detailed rules in all member states conceals unchanged old differences.[658] In Italy for example, the Italian accounting system has altered slightly even though the requirement from 1 Jan 1993 that Italian financial statements should give a representation which is *veritiero e corretto* led to changes in the law and audit reports.[659] There's a transatlantic distinction regarding the **concept of fairness**: In the EU Directives, fairness is an overriding concept whilst in the US, practice is to "present fairly in conformity with generally accepted accounting principles."[660]

In Germany however, there is still no legal preference for fairness over rules or for substance over form.[661] The main actors exerting an influence in their desire for change are some German multinationals who wish for greater access to international capital markets.[662] Such access can be achieved through the preparation of consolidated statements which are not in accordance with normal German rules and practices.[663] Since 2001, large listed companies in Germany have

655 SJ Gray, 'Towards a Theory of Cultural Influence on the Development of Accounting Systems Internationally, pp 1-15 Vol 24 No 1 Abacus
656 ibid
657 ibid
658 Nobes and Parker p 35
659 ibid
660 ibid
661 Ibid p 36
662 ibid
663 ibid

increasingly used US or International Financial Reporting Standards (IFRSs) accounting for their consolidated statements.[664]

7.17.5 Compliance with Basel Capital Accord: How Does the UK Rank in Comparison to Other Investigated Jurisdictions?

In the same manner as Italy, prudential regulations in Germany are based to a great extent on international standards and on the Basel Capital Accord and the EC Directives in particular.[665] The *Deutsche Bundesbank* has been a member of the Basel Committee on Banking Supervision since its inception and also works with other international banking supervisory bodies such as the Banking Supervision Committee of the ESCB (European System of Central Banks), the Banking Advisory Committee, Groupe de Contact, the International Organisation of Securities Commissions, the Financial Stability Forum and the Committee on the Global Financial System.[666] As stated in the concluding section of chapter two, an effective global regulatory regime appears to be a task which can only realistically be achieved through co-operation between national regulators.

The FSA recognises that all sources of regulation, be it domestic or international, not only present cost issues, but are also capable of distorting markets.[667] There is also an acknowledgement that global committees contribute immensely to the domestic, EU and international rule making processes. In addition to the collaboration forged with the Basel Committee on Banking Supervision, the FSA also collaborates with the Committee of European Securities Regulators, the Committee of European Banking Supervisors, the Committee of European Insurance and Occupational Pensions Supervisors, the Financial Stability Forum, the Joint Forum[668], the International Organization of Securities Commissions (IOSCO) and International Association of Insurance Supervisors (IAIS).[669]

The adoption of the Basel II Accord appears to be the most feasible way of achieving global regulatory harmonisation. In June 2006, the implementation of Basel II at European level was initiated through the Banking Directive (2006/48/EC) and the Capital Adequacy Directive

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664 C Nobes and R Parker, *Comparative International Accounting* p 569

665 Deutsche Bundesbank's Involvement in Banking Supervision p 39

666 Ibid p 40

667 See FSA Report, 'International Regulatory Outlook' December 2006 p 33

668 Which consists of national regulators, Basel, IOSCO (the International Organization of Securities Commissions) and IAIS (International Association of Insurance Supervisors)

669 See FSA Report, 'International Regulatory Outlook' December 2006 pages 45-52

(2006/49/EC).[670] Whilst Germany[671], Italy[672] and the UK[673] have implemented Basel II, there has been a delay in the US in implementing Basel II.[674] Delay in implementing Basel II in the US may be attributable to the US' complex system of regulation. The positive thing to observe is that even though implementation is not as speedy as one might wish, it is still taking place.

7.17.6 Future Outlook: What Now After Enron (and the 2007/08 Financial Crisis)? Proposals For Reform

First Proposal:

As is the case with bank regulation and supervision in Germany, there should be a greater role for and greater involvement of the Bank of England in the bank supervisory process than is the case at present. The Northern Rock crisis highlighted the following problems inherent in the tripartite arrangement between the Treasury, the Financial Services Authority and the Bank of England for dealing with financial stability:[675] As soon as Northern Rock encountered problems, it was virtually impossible for the Bank of England to perform its traditional role as lender of last resort as such role was required to be made public – even though the risk of destroying confidence in the mortgage lender existed.[676] The Treasury has proposed to restore to the central bank its ability to lend to a troubled bank for a limited period whereby the public would not be aware of such – hence avoiding a situation of panic

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670 See <http://www.bundesbank.de/bankenaufsicht/bankenaufsicht_basel.en.php> (last visited 30 April 2008)

671 Basel II's incorporation in Germany, into national law was not only facilitated through changes to the Banking Act, but also by means of additional regulations, particularly the Solvency Regulation (Solvabilitätsverordnung) which was published in mid-December 2006 and the Regulation governing large exposures and loans of €1.5 million or more (*Groß- und Millionenkreditverordnung*);ibid

672 In accordance with the EU's Capital Adequacy Directives 2006/48 and 2006/49 on the taking up and pursuit of the business of credit institutions and the capital adequacy of investment firms and credit institutions respectively, the so-called Basle II capital-adequacy principles will take effect as from January 1st 2007. The exception will be for financial institutions adopting more sophisticated methods of risk calculation, who will be allowed to adopt the principles on January 1st 2008.

673 In the UK, rules relating to the new risk based capital regime (as introduced by the Capital Requirements Directive, CRD), were formally finalised in October 2006. 2007 however, is intended to be a transitional year with firms having the option to continue with Basel based rules for all or part of 2007. All firms subject to the CRD must have adopted the regime by the 1st of January 2008: (see http://www.fsa.gov.uk/pubs/iro/iro_2006.pdf), International Regulatory Outlook, December 2006, FSA, page 12)

674 ibid

675 See W Buiter 'The Lessons from Northern Rock' *The Financial Times* Nov 13 2007

676 See also 'Avoiding the Next Northern Rock: The Treasury has Learned Some Expensive Lessons' *The Economist* January 31st 2008

and a "run" on the bank.[677] The second problem comprised of an ineffective scheme of deposit insurance.[678] A run might still have been avoided (after it had been revealed that the Bank of England had provided emergency loan to Northern Rock) if an effective deposit insurance scheme had been in place.[679] The Treasury proposes an element of pre-funding which should provide some relief to a banking industry concerned about having to provide an entirely funded scheme.[680] Perhaps the most important of the proposed reforms relates to the problem whereby during the Northern Rock crisis, the government lacked powers to withdraw control from Northern Rock's board and shareholders even though the bank was being funded with tax payer's money. As a response to this problem, the establishment of a "special resolution regime" which should enable the seizure of a failing bank and facilitate all or part of its business to be transferred to a "bridge bank" which would manage services for customers, has been proposed.[681] The FSA is most likely to be in charge of the oversight of these new powers.[682] The Bank's role in ensuring financial stability is also to be strengthened. The tenure of the present Governor of the Bank, Mervyn King, has been extended to provide some degree of certainty at a time when the markets are unsteady. In addition to strengthening the Bank's role in ensuring financial stability, plans are being made over the next months to grant to the FSA, the US style of plea bargaining powers.[683] This is aimed at encouraging wrong doers to admitting their faults in return for leniency.

(Following the original publication of this thesis in September 2008, the Banking Act 2009 was introduced. The special resolution regime constitutes the focal point of the Banking Act 2009 in respect of measures aimed at dealing with failing banks. It is the new statutory and permanent regime which consolidates temporary measures introduced by the Banking (Special Provisions) Act 2008 (BSPA) which was implemented as a means of exercising control and bringing Northern Rock into temporary public ownership in February 2008. According to Part 1, section 1 (1) of the Act, the purpose of the special resolution regime for banks is to address the situation where all or part of the business of a bank has encountered,

[677] Supra notes 675 and 676
[678] See W Buiter 'The Lessons from Northern Rock' *The Financial Times* Nov 13 2007
[679] ibid
[680] ibid
[681] ibid
[682] ibid
[683] See B Barrow ,£300,000 bonuses for the FSA watchdogs who watched Northern Rock collapse' *Daily Mail* March 28 2008

or is likely to encounter financial difficulties. The special resolution regime consists of [684] three stabilisation options,[685] the bank insolvency procedures[686] and the bank administration procedures).[687]

(The Banking Act 2009 not only consolidates the tripartite arrangement as established under the 2006 Memorandum of Understanding, but is also evidential of the extension of the Bank of England's role in the supervisory process. This is reflected in sections such as those of 7 and 8 of the Act, which clarify responsibilities in relation to the exercise of powers. In respect of bank insolvency procedures, an insolvency order may be made only on the application of the FSA with the consent of the Bank of England, or on the application of the Bank of England (See section 117(2) of the Act). Further, before exercising insolvency powers in respect of a residual bank, the FSA is required to give notice to the Bank of England. In Germany, the perception that the allocation of responsibilities between the *Bundesbank* and BaFin had lacked clarity and transparency and had the potential to result in inconsistency and duplication of work, lead to the issue of a new Memorandum of Understanding in February 2008.[688] This followed a series of government bailouts of state owned banks in 2008 – which in part, was attributed to the systemic importance assumed by such banks and the potential disastrous consequences which could occur if they had been allowed to fail).[689]

As well as assuming a greater role within the supervisory process and collaborating with the FSA, the Bank of England would greatly contribute to the supervisory process as a result of its use of external auditors - in a way similar to that employed by the *Bundesbank*. In addition to the employment of auditors to conduct trading activities on behalf of the Federal Financial Supervisory Office and audits to determine the adequacy of institutions' market

[684] Section 2 of the Act
[685] See section 1 (3a-c) : These are a) transfer to a private sector purchaser b) transfer to a bridge bank, and c) transfer to temporary public ownership
[686] As stated under Part 2
[687] As provided under Part 3
[688] See W Nier, 'Financial Stability Frameworks and the Role of Central Banks: Lessons from the Crisis' IMF Working Paper WP/09/70 April 2009 at pages 21 and 22
[689] http://www.spiegel.de/international/business/0,1518,536635,00.html

risk models,[690] the *Bundesbank* has its own banking supervisory auditors (approximately 70 as of September 2000). As a result, the system of bank regulation and supervision in Germany could be said to involve a degree of on-site supervision and pro active monitoring. As illustrated by the *Legal & General* case, regulators in employing the expertise of external auditors, should also be more pro-actively involved in the supervisory process. As regards the involvement of supervisors during the investigation phase, supervisors of a firm are not as a general rule, directly involved in an investigation which is being pursued by Enforcement.[691] This approach has its advantages in maintaining a clear division between the conduct of the investigation on the one hand and the need to maintain the supervisory relationship with the firm on the other.[692] At the same time this division of responsibility may mean that the investigation does not benefit as much as it might otherwise do from the knowledge of the firm or individuals that the supervisor will have built up, nor from the general understanding of the firm's business or sector that the supervisor may be able to contribute.[693]

Financial crises such as those of Northern Rock, IKB and Hypo Real Estates in Europe, have lead to a review of arrangements involving the central banks in the jurisdictions concerned. The occurrence of these crises also highlighted the need for a special resolution regime and a "bridge bank" whose aims are to address the needs of failing banks.

Second Proposal

Greater use of external auditors should be encouraged not only in the UK but also in the US. As these jurisdictions' audit objectives focus more on investor protection, in comparison to Germany and Italy, there is greater need for the use of external auditors. This is not to say that Germany and Italy are not encouraged to make greater use of auditors. The Basel Committee also recommends greater use of external auditors within these jurisdictions. The reason for the UK FSA's reduced use of external auditors may be attributed to the dual role

690 Bundesbank's Involvement in Banking Supervision Monthly Report September 2000 p 37
691 <http://www.fsa.gov.uk/pubs/other/enf_process_review_report.pdf> p 30
692 ibid p 30
693 ibid

of the reporting accountant and skilled person which may result in a conflict of interests where the external auditor performs both roles – hence, compromising his independence. To avoid such conflicts of interest, separate persons should perform these roles and greater use of external auditors should be encouraged in the process. The adoption of a risk-based approach to supervision is one which should be applauded – however it should not provide an excuse for the reduced use of external auditors. Globalisation and conglomeration call for a risk based approach to supervision. A consolidated supervisor is also able to manage more efficiently cross-sector services' risks.

Third Proposal

Since Article 57(2) of the Treaty of Rome requires unanimity for the adoption of community measures concerning the protection of savings, what applies to banking depositors in Germany, Italy and France should also apply to policy holders in these countries and the UK.[694] In addition, the FSA should have some form of responsibility for loss caused to depositors as a result of its negligence – as is the case in Germany and Italy.

Fourth Proposal

The nature of the components of the expectations gap makes it difficult to eliminate[695]. Perceived performance of auditors is an element which is difficult to measure and changes constantly. It is possible to substantially reduce but not totally eliminate.

Periodical surveys should be carried out in the general public to ascertain what many perceive to be the role of an auditor. These surveys should be carried out only after the public has been sufficiently educated about the role of the audit. After this, draft proposals should be made whereby the public is involved and is invited to submit their ideas or challenge any proposals. The draft proposals on the definition of an audit should be a more acceptable definition by popular consensus – as realised through the opinions received from

[694] See Summary of Submission to the House of Lords Select Committee on the Accountability of the Financial Services Authority in general, and of the Accountability of the Government and of the Parliamentary Ombudsman Regarding the Equitable Debacle.

[695] See P Sikka A Puxty H Willmott and C Cooper ' The Impossibility of Eliminating the Expectations Gap: Some Theory and Evidence" December 2003. Sikka et al argue that due to social conflict the meaning of social practices continually face challenges and the gap between competing meanings of audit cannot be eliminated.

surveys carried out on the public. There should be an objective component within the definition of an audit which would be the public's reasonable expectations. These expectations could be deemed reasonable as public would already have been educated about the role of auditors, nature of audits before a survey is carried out to find out what the public want from an audit.

The subjective component definition of an audit would be revised from time to time – depending on social, environmental changes. The objective component would also be revised from time to time based on periodical surveys. In the absence of a duty to third parties, the fraud and error detection role of an auditor seems to be a role which should become a primary audit objective – as this would help bring about some form of accountability. Of course, the auditor cannot be expected to sniff out every form of fraud – only material ones.

In sum, various ways through which the individual components of the expectations gap could be reduced are as follows:

The Sub Standard Performance Component could be reduced by restoring the fraud and detection role as the main audit objective.

The Deficient Standards Component could be reduced through unambiguous wordings within Statements of Auditing Standards. These should be avoided and clearer definitions provided to give the auditor a better understanding of his duties.

In relation to the Unreasonable Expectations component, reasonable expectations of the public could be ascertained through education of the public about the role of the auditor and the auditing standards relating to his role. Public education about the auditor's role could be facilitated through annual shareholders' meetings and other events which are organised for the purposes of educating users of financial information. It would be more feasible to educate users of financial information as opposed to members of the general public – especially since not all members of the public use financial information.

Fifth Proposal

The more stringent regulations which exist in Italy such as not allowing external auditors to offer additional (non-audit services), appointing firms for longer periods of tenure, rotation of audit firms, restrictions on staff movement between firms and clients and monitoring audit fees/hours are factors which would facilitate a better environment for auditor independence. It would therefore be worthwhile considering the adoption of these measures in the UK. As stated previously, corporate governance structures, "thinness"[696] of the audit market and other relevant factors and jurisdictional differences would need to be considered when deciding whether or not to adopt certain measures.

Sixth Proposal

In relation to audit liability, auditors should be held liable for the negative consequences of their actions. A deterrent is needed in the form of a degree of liability which discourages the auditor from acting negligently or intentionally taking risks. However, there is need to ensure that such liability is not so high that it leads to defensive auditing. The introduction of liability caps as discussed in the next section should help achieve this balance.

The issue of audit liability in the UK could be addressed by the relatively newly introduced Companies Act 2006. However on a European level, a combination of variants of the European Commission's first and third options[697] could also serve as an option. The four options presented for reforming auditors' liability are as follows:[698]

The introduction of a fixed monetary cap at European level, which in the Commission's opinion, might be difficult to achieve.

The introduction of a cap based on the size of the audited company, as measured by its market capitalisation.

The introduction of a cap based on a multiple of the audit fees charged by the auditor to its client.

The introduction by Member States of the principle of proportionate liability, which means that

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[696] Audit markets with relatively few large clients are referred to as thin markets.
[697] The European Commission in its consultations relating to whether there is need for a reform of the auditor liability regime, not only presented four options, but also invited stakeholders to submit their opinions by 15 March 2007. For more on this, see < http://europa.eu/rapid/pressReleasesAction.do?reference=IP/07/60&format=HTML&aged=0&language=EN&guiLanguage=en>; also refer to the first chapter of this thesis.
[698] ibid; also see < http://ec.europa.eu/internal_market/auditing/liability/index_en.htm > (last visited 2 May 2008)

each party (auditor and audited company) is liable only for the portion of loss that corresponds to the party's degree of responsibility.

In relation to the European Commission's options, I would propose a model based on a combination which are variants of the first and third options, namely a combination of a single monetary cap at a European level and a cap based on audit fees[699]. Whilst a cap based on market capitalisation would be rather subjective, adopting a principle of proportionate liability, also involves subjective elements. According to the European Commission, the option relating to proportionate liability would not only consist in courts awarding damages which are in proportion to the auditor's fault, but also in contractual arrangements being negotiated between the company and its auditors and approved by shareholders.[700] In relation to the subjective nature of disproportionate liability, where does one draw a distinction between negligent acts and those acts committed intentionally? Whilst some negligent acts may result in greater losses, is this to imply that such unintentional acts should attract more severe punitive sanctions than intentional ones whose acts incurred fewer losses? Furthermore, how is one to distinguish between grossly negligent and mere negligent (simple negligent) acts, and how is one to apportion liability for those acts which are merely negligent but which have resulted to greater losses than grossly negligent acts? Do we apportion according to the losses incurred by the company or on the basis of the nature of the act? It seems that a response to these questions would necessitate a consideration and balance of those factors surrounding both the nature of the act, the extent and consequences of the losses incurred. For example, the impact of the loss on third parties and other affected stakeholders. These are issues which would have to be considered in the contractual arrangements being negotiated between the company and its auditors and approved by shareholders. These variants are introduced as follows:

In relation to the first option, I support a monetary cap at a European level. However, such cap would have to be defined since a fixed figure does not take into consideration the differences which exist in the audit environments of various EU member states. For example, whilst 5 million Euros may be deterrent for audit companies in Italy and Germany (as the market for audit services are not

[699] In considering a variant based on audit fees, the audit revenue generated by the audit firm is considered.
[700] See 'The European Federation of Accountants_ Federation des Experts Comptables Europeens' Paper <http://www.iwp.or.at/veranstaltungen/documents/unterlagen_2007-05-07.pdf>

as great as in the UK and the US)[701], it might not produce such a deterrent effect in the US or the UK. In defining what the cap should be, an appropriate determinant would be the revenue[702] generated by the audit firm. Revenue should not relate only to the audit fees generated by these firms, but also to fees generated from non audit services. However, a benchmark needs to be set in relation to the cap. This is so because if a cap were solely determined by the audit firm's revenue, those firms generating low revenues would be inclined to take greater risks. If a minimum figure were set depending on whether the firm was a medium sized or large audit firm (small sized audit firms should be exempted from liability in the same way as small companies are not mandated by law to carry out audits)[703], say x million Euros minimum for medium sized audit firms and y

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[701] Audit markets with relatively few large clients are referred to as thin markets. Germany has been classed as having a relatively thin market as relatively few companies are public limited companies (AGs). See MB Gietzmann and PK Sen, 'Improving Auditor Independence Through Selective Mandatory Rotation' (2002) 6 International Journal of Auditing 201

[702] The revenue generated by the audit firm constitutes the variant of the audit fees (third option as proposed by the European Commission). Reasons for a preference of revenue, instead of operating profit include the fact that operating profit is more subjective as costs are deducted (administration and distribution costs) in order to arrive at a profit figure. These deductions can provide a leeway for creative accounting, that is, the manipulation of accounts to achieve a desired figure (for taxation or penalty purposes). Ranges of audit revenues chosen by national regulators or the European Commission, to which different fines are imposed, in the event of audit liability, should also take into account the fact that some audit firms may generate the same revenue but not the same profit. The selected ranges could also determine the extent to which some firms would be tempted to manipulate their accounts in order to be classified or designated within a certain range. This is so, particularly if such range would attract lower fines. Whilst the difference between different ranges should not be so narrow as to make it easier for audit firm to "manipulate" its way into a more desirable range, it should also not be so wide as to compel certain firms to take greater risks. A means of achieving this balance would be to apportion fines in such a way, between the different ranges of audit revenues, that there are less incentives to resort to creative accounting practices.

[703] See Explanatory Memorandum to the Companies Act 1985 (Small Companies' Accounts and Audit) Regulations 2006.

Section 4.1 reads as follows: All companies are required by the 1985 Act to prepare annual accounts and to have those accounts audited. These requirements originate from EU directives.

> However, small companies can take advantage of less onerous accounting and reporting requirements. Under section 246 of the 1985 Act they can prepare and file at Companies House less detailed accounts and reports. Small companies do not have to have their accounts audited (sections 249A and 249AA).

Section 4.2 states:
To qualify as small, a company must meet two of the following criteria (set out in section 247 of the 1985 Act):

- its turnover in a financial year is not more than £5.6m,
- its balance sheet total for that year is not more than £2.8m, and
- it has not more than 50 employees.

Whilst section 4.3 states : Section 249 of the 1985 Act sets out similar criteria for qualifying as a small group. Under section 248 the parent company of a small group does not have to prepare group accounts.

million Euros minimum for large audit firms (y million Euros naturally being greater than x million Euros), then cases whereby caps are higher, would have to be justified according to the revenue generated by the medium or large sized audit firm. For example whilst the benchmark liability would apply to firms earning relatively low audit income within their class[704], higher penalty fees would apply to those earning higher revenues (within different specified ranges).

The minimal caps of x million Euros (medium sized audit firms) and y million Euros (large sized audit firms) should be deterrent enough to discourage such audit firms from taking undue risks.

Whilst I support the Commission's Working Paper proposal for a single monetary cap at European level, the designation as a medium or large sized audit firm would have to be determined by the revenues generated by these firms. The use of revenue generated by these firms should provide an objective basis even though the audit markets in various jurisdictions differ.[705] Thus, whilst numerous large sized audit firms may exist in the UK, this would not be the case in Germany[706] or Italy. Even though it has been argued that a single monetary cap is not appropriate,[707] I would only agree with the criticism that certain issues need to be clarified. Such issues as whether the liability cap applies separately to claims or once to the sum of claims, differences in laws of member states as regards direct claims by the company or third parties need to be addressed[708]. However these issues do not imply that the implementation of a single monetary cap at EU level is unworkable. Moreover in my opinion, it is preferable to the desired choice of Doralt and others[709] for the purpose of promoting harmonisation and facilitating greater cooperation between regulators on an international basis.

Also see Fourth Council Directive of 25 July 1978 (78/660/EEC) based on Article 54(3)(g) of the Treaty on the annual accounts of certain types of companies, OJ L222/11 of 14 August 1978. Seventh Council Directive of 13 June 1983 (83/349/EEC) based on Article 54(3)(g) of the Treaty on consolidated accounts, OJ L193/1 of 18 July 1983.

704 Classification as medium sized or large audit firm

705 ibid

706 Audit markets with relatively few large clients are referred to as thin markets. Germany has been classed as having a relatively thin market as relatively few companies are public limited companies (AGs).

707 See W Doralt and others, 'Auditors' Liability and Its Impact On The European Financial Markets' (2008) 67 Cambridge Law Journal 64

708 ibid at 63

709 See W Doralt , A Hellgardt, K J Hopt, P C Leyens, M Roth and R Zimmermann 'Auditors' Liability and Its Impact On The European Financial Markets' (2008)

Source of table[710]

Indicative overall reaction of the respondents towards a possible reform of auditors' liability regime		
In favour of limitation	**N°**	**%**
yes (audit profession)	30	35 %
yes (outside the profession)	26	31 %
no	25	29 %
neutral	4	5 %
TOTAL	85	100%

General Response of Audit firms to Recommendation on Limiting Audit Firms' Liability

Whilst limited liability was favoured by most respondents in their response to the European Commission's proposals,[711] it has been argued that proportional auditor liability is unlikely to address audit market failure.[712] Furthermore, it is contended that the distortion of market incentives in audit markets can be traced to government intervention and that a solution can be found by replacing government intervention with competition.[713]

Opinions of major audit firms [714]

A total of 85 responses which consisted of opinions from the audit profession, companies, banks, regulators and other stakeholders were obtained.[715] 66% of the responses were in favour of a limitation on auditors' liability - with the audit profession accounting for slightly over half of

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710 See http://ec.europa.eu/internal_market/auditing/docs/liability/impact_assessment_en.pdf (page 61 of 79)

711 Vital argument against unlimited liability consists in the fact that it cannot be insured sufficiently/at all.

712 See B Köhler, 'Audit Market Failure' (2009) Economic Affairs, Vol 26 (3) at 67- 69

713 ibid

714 Responses of respondents can be found at: <http://circa.europa.eu/Public/irc/markt/markt_consultations/library?l=/abschlussprfung/abschlussprfern&vm=detailed&sb=Title> (last visited 27 April 2009)

715 See http://ec.europa.eu/internal_market/auditing/docs/liability/impact_assessment_en.pdf (page 6 of 79)

respondents who supported a limitation on auditors' liability.[716]

6 of these responses will be considered. Even though the sample may at first appear to be non representative, given its size, it is considered to be sufficient for the purposes at hand, namely, an estimation of the general opinion of audit firms. This is so, since the Big Four, which account for the 'lion's share' in the provision of audit services are included in the sample. Furthermore, all the audit firms being investigated are major audit firms. The audit firms whose responses will be investigated are as follows: Deloitte, Ernst and Young, Institut der Wirtschaftsprüfer, Institute of Chartered Accountants in England and Wales, KPMG, and PricewaterhouseCoopers.

The table below for auditors' liability illustrates that tort law accounts for the basis of auditors' liability, in respect of third parties, in most of the EU member states featured. As a result, harmonisation at European level, on the basis of contractually arranged caps, would not be feasible.[717] Furthermore, contractual limitation as is the case with the UK, is not favoured since in many other member states, auditors owe a duty of care not only to the company and its shareholders, but to other third parties.[718] Harmonisation could be achieved through statutory means.

Key Principles to be followed when Limitation Method is selected by Member States

- The limitation of liability should not apply in the case of intentional misconduct on the part of the auditor

- A limitation would be inefficient if it does not also cover third parties

- Damaged parties have the right to be fairly compensated

The Recommendation appears to permit a wide scope in prescribing how Member States should implement a limitation of audit firms' liability. Even though this could be aimed at ensuring greater

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716 ibid; Of the 66%, 35% consisted of the audit profession and 31%, the non audit profession. The figure attributed to those who were not in favour of a limitation on auditors' liability was 29%.

717 See page 32 of 79 <http://ec.europa.eu/internal_market/auditing/docs/liability/impact_assessment_en.pdf>

718 Third parties such as banks, creditors, individual shareholders or groups of minority shareholders and even potential shareholders. Auditors would not be able to contractually limit their liability with these third parties.

flexibility due to differences in audit liability regimes operating in various states, the degree of guidance provided by the European Commission is also vital for purposes of compliance and enforcement of the Recommendation. This contrasts with the 2006 Directive on Statutory Audit[719] which sets out more detailed guidelines to be followed by Member States. Furthermore, the 2006 Directive appears to have as one of its objectives, the goal of harmonisation. Section 32 of its preamble reads:

- "Since the objectives of this Directive — namely requiring the application of a single set of international auditing standards, the updating of the educational requirements, the definition of professional ethics and the technical implementation of the cooperation between competent authorities of Member States and between those authorities and the authorities of third countries, in order further to enhance and harmonise the quality of statutory audit in the Community and to facilitate cooperation between Member States and with third countries so as to strengthen confidence in the statutory audit — cannot be sufficiently achieved by the Member States and can therefore, by reason of the scale and effects of this Directive, be better achieved at Community level, the Community may adopt measures, in accordance with the principle of subsidiarity as set out in Article 5 of the Treaty."-

Closer examination of the three methods put forward by the Commission in limiting liability reveals that the goal of harmonisation still constitutes a focal point. However, harmonisation would be made the more difficult given the degree of flexibility allowed by the European Commission in permitting Member States to decide on the appropriate method for limiting liability. Even though the above mentioned key principles would still serve to provide some guidance to Member States, the methods to be applied by such states in limiting liability could have been stipulated by the Commission according to the prevailing legal basis for auditors' liability in those member states.

In addition to stipulating methods which would apply, and which are based on the prevailing legal basis for auditors' liability, consideration should also be given to those countries where liability caps presently exist. This would have been considered by the European Commission based on the

[719] DIRECTIVE 2006/43/EC OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 17 May 2006 on statutory audits of annual accounts and consolidated accounts, amending Council Directives 78/660/EEC and 83/349/EEC and repealing Council Directive 84/253/EEC

response from these jurisdictions. The response[720] obtained from the countries (see below) indicated that 74.1% of respondents from outside the audit profession and from countries where audit limitation caps are in place (including the UK, Germany and Austria) favoured reform on European basis – provided significant amendments would not be required to their national laws. As a result of the Commission's Recommendation, would (and should) substantial amendments to the national legislation in such countries be required?

[720] See page 61 of 79 of the Impact Assessment Document

Legal base (contractual or tort law) for auditors' liability in EU-15 Member States

Country	Audited company	Third party
Austria	Contractual[121]	Contractual/tort[122]
Belgium	Contractual/tort	Tort
Denmark	Contractual	Tort
Finland	Tort	Tort
France	Tort	Tort
Germany	Contractual/tort	Contractual/tort
Greece	Contractual	Tort
Ireland	Contractual/tort	Tort
Italy	Contractual	Tort
Luxemburg	Contractual	Tort
Netherlands	Contractual	Tort
Portugal	Contractual/tort	Contractual/tort
Spain	Contractual	Tort
Sweden	Contractual	Tort
United Kingdom	Contractual/tort	Tort

Source: <http://ec.europa.eu/internal_market/auditing/docs/liability/impact_assessment_en.pdf> page 75 of 79

Evaluating the European Commission's Recommendation

Having considered the responses of all six firms[721], a recurring response was the opinion that proportionate liability should not operate in isolation as this could place mid tier audit firms at a disadvantage. This is due to the fact that they may not have the financial resources required to respond to claims of excessive amounts. Whilst a combination with some form of absolute protection such as limitation by contractual agreement has been considered, difficulty in implementing such a proposal is foreseen since in many other member states, unlike the UK, the auditor's duty of care is much wider.[722]

In such a situation, it would be difficult to limit their liability contractually with such third parties. Difficulties are also anticipated in implementing the proposal that proportionate liability be combined with absolute protection and enshrined in EU legislation. In this respect, the fact that liability caps already exist in some member states like Austria, Belgium, Germany, Greece and Slovenia needs to be considered. Proportionate liability by law as from 1st Jan 2008, was introduced in Hungary whilst contractual limitations of liability applied in the UK as from June 2008.

However, the reforms in these jurisdictions only apply within local boundaries. Reform is required in order to introduce a law which can apply at European level. Based on the results obtained from the consultation, 74.1% of respondents from outside the audit profession and from countries where audit limitation caps are in place (including the UK, Germany and Austria) favoured reform on European basis - provided significant amendments would not be required to their national laws. On the other hand, 76.5% of the respondents from outside the audit profession and in those countries where liability caps do not presently operate, do not favour liability caps.[723]

Given the high percentage of respondents in those countries where liability caps do not presently

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721 For a more detailed analysis of these responses, please see M Ojo, 'Limiting Auditors' Liability: A Step in the Right Direction ?" (Proposals for a New Audit Liability in Europe Revisted)<http://mpra.ub.uni-muenchen.de/14878/>Even though the sample may at first appear to be non representative, it is considered to be sufficient for the purposes at hand, namely an estimation of the general opinion of audit firms.

722 In these jurisdictions, the auditor owes a duty of care not only to the company and its shareholders, but also to other third parties such as banks, creditors, individual shareholders and in some cases, potential shareholders.

723 See page 61 of 79 of the Impact Assessment Document

operate and who do not favour liability caps, and considering the fact that significant amendments to national laws would not be welcomed in those countries where liability caps presently exist, the flexibility afforded by the European Commission in its Recommendation on Limiting Auditors' Liability, is justified. However, a price will be required in allowing for **such a degree** of flexibility. The success of harmonisation and enforcement at European level despite prevailing differences in national regimes, will require that resulting immense challenges, be overcome by supranational authorities.

A variant of a fixed monetary cap at European level and the introduction of a cap based on a multiple of the audit fees charged by the auditor to its client, would have presented a better opportunity for harmonisation and that - without the need for (as many) significant changes to the national legislation of several EU member states.

CASE LAW

UK

AGIP (Africa) Limited v Jackson & Others (1990)1 Ch. 265

Bank of Credit and Commerce International (Overseas) Ltd (in liquidation) and others v Price Waterhouse and Another (No 3) [1999] 4 All E.R. 83

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Candler v. Crane, Christmas & Co. [1951] 2 K.B. 164; [1951] 1 All E.R. 426, C.A.

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Hedley Byrne & Co. Ltd. v. Heller & Partners Ltd. [1964] A.C. 465; [1963] 3 W.L.R. 101; [1963] 2 All E.R. 575, H.L.(E.)

Hill v. Chief Constable of West Yorkshire [1989] A.C. 53; [1988] 2 W.L.R. 1049; [1988] 2 All E.R. 238, H.L.(E.)

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London and General Bank (No2)[1895]

Mutual Life and Citizens' Assurance Co. Ltd. v. Evatt [1971] A.C. 793; [1971] 2 W.L.R. 23; [1971] 1 All E.R. 150, P.C.

Re Equitable Life Assurance Society [2007] EWHC 229 (Ch)

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Re Kingston Cotton Mills (No 2) [1896]

Re Pearl Assurance (Unit Linked Pensions) Ltd [2006] EWHC 2291 (Ch); (2006) 103(38)L.S.G. 33; (2006) 150 S.J.L.B. 1250; [2007] Bus.L.R.D10; (Ch D (Companies Ct))

AUDITING STANDARDS

(Communication by Auditors) Regulations 2001 ("the 2001 Regulations")SAS 120 Revised: Consideration of Law and Regulations

See SAS 620 Revised: The Auditor's Right and Duty to Report to Regulators in the Financial Sector
IFRS 32 and IFRS 39
ISA (UK and Ireland) 240 : The auditor's responsibility to consider fraud in an audit of financial statements paragraphs 44 and 45

See ISA (UK and Ireland) 250 section B paragraph 54 of the Auditor's Right and Duty to Report to Regulators in the Financial Sector

STATUTES

Bank of England Act 1946
Banking Act 1979
Banking Act 1987
section 1(1)
chapter 22, Part 1 section 1(1)
sections 36-38
section 39
section 41
Section 247(3)(c)
section 744
Schedule 3
Part V

Bank of England Act 1998
Section 21

Banking Coordination Regulations 1992
Building Societies Act 1986 section 101(4)

Companies Act 1985
Sections 236 and 237

Section 246
Section 247
Section 248
Sections 249A and 249AA
Section 310

Companies Act 1989

Companies Act 2006
Sections 532
Section 533
Sections 534 –536

Company Law Reform Bill

Financial Services Act 1986
Financial Services Act 1986 s 28
Financial Services Act 1986 s59

Financial Services Act 1986 s61(1)
Financial Services Act 1986, sections 65-68

Financial Services and Markets Bill
Financial Services and Markets Bill clause 40
Financial Services and Markets Bill clause 98
Financial Services and Markets Bill clause 110
Financial Services and Markets Bill clause 113
Financial Services and Markets Bill clauses 166-169
Financial Services and Markets Bill clause 332

Financial Services and Markets Act 2000

Financial Services and Markets Act 2000

Financial Services and Markets Act 2000 s 2

Financial Services and Markets Act 2000 s 3-6

Financial Services and Markets Act 2000 s 6 (5)

Financial Services and Markets Act 2000 s 8-11

Financial Services and Markets Act 2000 s 64

Financial Services and Markets Act 2000 (c.8) s.105 (2)(a)
Financial Services and Markets Act 2000 (c.8) s.105
Financial Services and Markets Act 2000 (c.8) s.110
Financial Services and Markets Act 2000

Financial Services and Markets Act 2000 s 119

Financial Services and Markets Act 2000 s 158
Financial Services and Markets Act 2000 s 342
section 6 of Schedule 1 Part 1 - section 6(1)

Financial Services and Markets Act 2000 Schedule 2 Part 1
Financial Services and Markets Act 2000 s 165
Financial Services and Markets Act 2000 s 166
Financial Services and Markets Act 2000 sections 167 and 168
Financial Services and Markets Act 2000 section 169
Financial Services and Markets Act 2000 section 284
Financial Services and Markets Act 2000 Schedule 1, Part III, paragraph 17
Financial Services and Markets Act 2000 s 316,318,328
Financial Services and Markets Act 2000
Financial Services and Markets Act 2000 (c.8) s.111
Financial Services and Markets Act 2000 (c.8) Part VII
Financial Services and Markets Act 2000 (c.8) s.112
Financial Services and Markets Act 2000 (c.8) Part 7

Insurance Companies Act 1982 (c.50) Sch.2C
Insurance Companies Act 1982 (c.50) s.49

The Unfair Contract Terms Act 1977

UK Companies Act 1981

INTERNATIONAL

Banking Directive (2006/48/EC)
EC Regulation 1606/2002
EC Fourth Directive

Eighth EU Council Directive
EC E Money Directive
EU's Capital Adequacy Directives 2006/48 and 2006/49
EU Financial Conglomerates Directive
EU Market Abuse Directive 2003/6/CE
Fourth Council Directive of 25 July 1978 (78/660/EEC) based on Article 54(3)(g) of the Treaty on the annual accounts of certain types of companies, OJ L222/11 of 14 August 1978.
Second Consolidation Directive
Seventh Council Directive of 13 June 1983 (83/349/EEC) based on Article 54(3)(g) of the Treaty on consolidated accounts, OJ L193/1 of 18 July 1983.

Statutory Audit Directive (Article 2(13) of the Directive 2006/43/EC)
The Second Council Directive (Banking Coordination Regulations 1992)

GERMANY

Banking Act of 1961
The Basic Law, *Grundgesetz*
First Act Amending the Banking Act
Fourth Act Amending the Banking Act
Fourth Financial Markets Enhancement Act
Fourth Financial Market Promotion Act
Gesetz ueber die integrierte Finanzaufsicht 2001 (*Gesetz über die Bundesanstalt für Finanzdienstleistungsaufsicht – Finanzdienstleistungsaufsichtsgesetz)*
Gesetz ueber das Kreditwesen
Gesetz zur Errichtung der Bundesanstalt fuer Finanzdienstleistungsaufsicht
Investment Act 2004
Investment Tax Act
Large Exposure Directive
Second Act Amending the Banking Act
section 317 of the German Commercial Code
Solvency directive *Solvenzverordnung*
Third Act Amending the Banking Act
Versicherungsaufsichtsgesetz – VAG the Insurance Supervision Act
Wertpapierhandelsgesetz – WpHG the Securities Trading Act
VAG section 81 and WpHG section 41

ITALY

Amato Law (218/1990)
Banking Law 1926
Banking Law 1936
Banking Law 1993
Codice Civile e Leggi Collegate 1995/96
Italian Civil Code 1942 (Article 2403)
Italian Civil Code 1942 (Article 2423)

Italian Civil Code 1942 (Article 2488)
Italian Legislation , Law 262 of December 2005
Law 216/1974
Law 588 of 19 November 1996
Legislative Decree no 127 (1991)
Legislative Decree no 58 of the 24 February 1998
Legge Comunitaria 2004
Legislative Decree 37/2004
Presidential Decree No 136 of 1975

US

1913 Federal Reserve Act
Glass Steagall Act (1933 Banking Act)
Gramm-Leach-Bliley Act
McFadden Act of 1927
National Bank Act of 1984
Private Securities Litigation Reform Act
Sarbanes Oxley Act
Securities Act of 1933
Securities Exchange Act of 1934

ABBREVIATIONS AND MEANINGS

ACCA	**Association of Chartered Certified Accountants**
AIDB	**Accountancy Investigation and Discipline Board**
APB	**Auditing Practices Board**
ASB	**Accounting Standards Board**
APER	**Statements of Principles and Code of Practice**
ARROW	**Advanced Risk-Responsive Operating Framework**
BaFin	**Bundesanstalt fuer Finanzdienstleistungsaufsicht (The Federal Financial Supervisory Authority)**
Basel II	**Updated Version of the International Convergence of Capital Measurements and Capital Standards: A Revised Framework**
BCBS	**Basel Committee on Banking Supervision**
BCCI	**Bank of Credit and Commerce International**
BCD	**Banking Consolidation Directive**
BoBS	**Board of Banking Supervision**
BoE	**Bank of England**
C(AICE) Act 2004	**Companies (Audit, Investigations and Community Enterprise) Act 2004**
CCAB	**Consultative Committee of Accountancy Bodies**

CEO	**Chief Executive Officer**
CICR	**Comitato Interministeriale per il Credito ed il Risparmio**
COND	**Threshold Conditions**
CONSOB	**Commissione Nazionale per le Societa e la Borsa** **(The Italian Securities and Exchange Commission)**
Covip	**Commissione di vigilanza sui fondi pensione**
DTI	**Department of Trade and Industry**
EC	**European Community**
EEA	**European Economic Area**
EEC	**European Economic Community**
EU	**European Union**
FASB	**Financial Accounting Standards Board**
FDIC	**Federal Deposit Insurance Corporation**
FEE	**Federation des Experts Comptables Europeens**
FESE	**Federation of European Securities Exchanges**

FinDAG **Gesetz über die Bundesanstalt für Finanzdienstleistungsaufsicht – Finanzdienstleistungsaufsichtsgesetz**

FIT	**Fit and Proper Test for Approved Persons**
FRB	**Federal Reserve Board**
FRC	**Financial Reporting Council**
FRRP	**Financial Reporting Review Panel**
FRS	**Financial Reporting Standard**
FSA	**Financial Services Authority**
FSI	**Financial State Insurance**
FSMA	**Financial Services and Markets Act 2000**
FSMB	**Financial Services and Markets Bill**
FTSE	**Financial Times Stock Exchange (London Stock Exchange)**
GDP	**Gross Domestic Product**
HGB	**Handelsgesetzbuch**
HM Treasury	**Her Majesty's Treasury**
KwG	**Kreditwesengesetz (The Banking Act)**
IAIS	**International Association of Insurance Supervisors**
IAS	**International Accounting Standards**

IASB	**International Accounting Standards Board**
IASC	**International Accounting Standards Committee**
ICAEW	**Institute of Chartered Accountants in England and Wales**
ICAS	**Institute of Chartered Accountants in Scotland**
ICAI	**Institute of Chartered Accountants in Ireland**
IFAC	**International Federation of Accountants**
IFRS	**International Financial Reporting Standard**
Isvap	**Istituto per la vigilanza sulle assicurazioni private e di interesse collettivo**
IMRO	**Investment Management Regulatory Organisation**
IOSCO	**International Organisation of Securities Commissions**
IPRU	**Interim Prudential sourcebooks**
IPRU (BANK)	**Interim Prudential Sourcebook for Banks**
JMB	**Johnson Matthey Bankers**
LSE	**London Stock Exchange**
MOU	**Memorandum of Understanding**
N2	**Date at which FSA assumed its full powers which is from December 1 2001**

OCC	**Office of the Comptroller of the Currency**
OECD	**Organisation for Economic Co-operation and Development**
OTC	**Over the Counter (derivatives)**
OTS	**Office of Thrift Supervision**
PIA	**Personal Investment Authority**
POB	**Professional Oversight Board**
POBA	**Professional Oversight Board for Accountancy**
PPI	**Payment Protection Insurance**
PRIN	**Principles for Businesses**
RDC	**Regulatory Decisions Committee**
RSBs	**Recognised Supervisory Bodies**
SAS	**Statement of Auditing Standards**
SEC	**Securities and Exchange Commission**
SFA	**Securities and Futures Authority**
SIB	**Securities and Investments Board**
SIPC	**Securities Investor Protection Corporation**
SRO	**Self Regulating Organisation**

SUP	**Supervision (Regulatory process of FSA Handbook)**
TCF	**Treating Customers Fairly**
UIC	**Ufficio Italiano dei Cambi (The Antitrust Authority)**
UITF	**Urgent Issues Task Force**
UK	**United Kingdom**
UKLA	**Listing Authority**
US	**United States**

GLOSSARY OF TERMS

***Aktiengesellschaft* (AG)** Company limited by shares which may be traded on the stock market. In the UK, this is referred to as PLC (Public Limited Company)

Audit Committees Audit committees are composed of independent non executive directors, one of which is usually a financial expert.

Audit Concentration Audit concentration can be said to exist in a market where as few as four firms, account for such a substantial share of the audit work undertaken in the markets.

Auditor Independence The ability to resist client pressure.[1]

Big Bang Process whereby City markets (London Stock Exchange) opened to outside markets – this mainly occurring through restructuring of the London Stock Exchange. The abolishment of exchange controls took place.

Capital Adequacy Term used to describe the adequacy of a bank's aggregate capital in relation to the risks which arise from its assets, its off-balance sheet transactions, its dealing operations and all other risks associated with its business.[2]

Conglomerates According to the Organisation for Economic Cooperation and Development (OECD) definition, conglomerates are referred to as heterogenous financial groups whose activities for the most part, span all institutional sectors.

Corporate Governance According to the Cadbury Committee definition, "The system by which companies are directed and controlled"

Creative Accounting The manipulation of financial figures to achieve a desired result.

Defensive Auditing The practice whereby auditors, rather than exercising their professional judgment, resort to excessive application of rules or audit standards as a means of justifying the results of the audit report.

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[1] Knapp; 1985

[2] J Hitchins, M Hogg and D Mallet, *Banking : A Regulatory Accounting and Auditing Guide* (Institute of Chartered Accountants 2001) 163

Deregulation Deregulation refers to the relaxation or removal of regulatory constraints on firms or individuals.[3] Deregulation has become increasingly equated with promoting competition and market-oriented approaches toward pricing, output, entry and other related economic decisions.[4]

Expectations Gap The difference between what users of financial statements, the general public perceive an audit to be and what the audit profession claim is expected of them in conducting an audit.

Meta Risk Regulation The use of firm's own internal risk management systems to achieve regulatory objectives. It differs from the FSA's risk regulatory procedures which involve a consideration of external risks.

Moral Hazard A situation which occurs when risks are taken because of the absence of incentives to deter from taking such risks.

Off-site Supervision is synonymous with monitoring and involves the regulator making use of external auditors.

On-site Supervision is usually done by the examination staff of the bank supervisory agency or commissioned by supervisors but may be undertaken by external auditors.

Over regulation This can be regarded as a situated whereby rules are excessively imposed. This usually has the effect of minimising competition.

Prudential regulation Regulation which focuses on the solvency and safety and soundness of financial institutions.

[3] ibid
[4] ibid

Regulation	Regulation can broadly be defined as the imposition of rules by government, supported by the use of penalties that are intended specifically to modify the economic behaviour of individuals and firms in the private sector.[5]
Regulatory capture	Generally defined as capture of the regulator by the regulated .
Self regulation	This form of regulation is one which professions adopt to develop and self-enforce rules which are commonly arrived at for the mutual benefit of members.[6] Self-regulation may be adopted in order to maintain professional reputation, education and ethical standards.[7] They may also act as a vehicle to set prices, restrict entry and ban certain practices (e.g., advertising in order to restrict competition).[8]
Supervision	The process of monitoring imposed rules.
Systemic risk	Systemic risk refers to the risk of a bank-run affecting other parts of the financial system thereby resulting in economic instability.
Threshold Conditions	The minimum criteria for granting permission to carry out regulated activities as provided by the FSA.

[5] See Organisation for Economic Cooperation and Development Glossary of Statistical Terms, < http://stats.oecd.org/glossary/detail.asp?ID=3295> (last visited 1July 2008)
[6] ibid
[7] ibid
[8] ibid

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