The External Auditor's Role in Bank Regulation and Supervision : Helping the Regulator Avoid Regulatory Capture.

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THE EXTERNAL AUDITOR'S ROLE IN BANK REGULATION AND SUPERVISION : HELPING THE REGULATOR AVOID REGULATORY CAPTURE

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ABSTRACT

The incoming Labour administration in 1997 caused a stir when it gave the Bank of England additional monetary policy powers but removed the Bank's powers to regulate banking. Up till 1997, banking regulation had been the function of the Bank of England while other areas of financial services had been regulated by bodies such as: The Securities and Investment Board (for investment business) and the Department of Trade and Industry (for insurance). Section 21 of the Bank of England Act 1998 effectively transferred banking supervision to the Financial Services Authority (then known as the Securities and Investments Board). This paper amongst other objectives, aims to explore how the Financial Services Authority (the FSA) as a regulator, could benefit from the expertise of the external auditor as a middleman, to avoid regulatory capture. As an efficient system of accountability would also help prevent regulatory capture, the issue of accountability will also be discussed. A consideration of developments leading to the adoption of a single regulator in the UK, will illustrate how the type of regulator can contribute to knowledge of how the external auditor can assist the regulator. Furthermore, not only does this paper consider how the introduction of the FSA has improved transparency and accountability within the banking regulatory and supervisory system, but also the claim that the external auditor could further employ his expertise to help the regulator avoid regulatory capture.

A. INTRODUCTION

Regulatory capture can generally be described as the capture of a regulator by the regulated. One might question why a bank regulator requires the help of a financial intermediary such as the external auditor. The claim about the external auditor's role in the regulatory and supervisory process relies on a number of cases, auditing standards and comparative analysis with other jurisdictions. The validity of the external auditor's role is also based on global developments, modern technology and change – which have influenced cases such as BCCI, Barings and Enron and also influenced auditing standards. The collapses of BCCI, Barings and Enron reveal the critical role played by external auditors and informational intermediaries in the disclosure of vital information. From these cases, a number of problems including the need for continuous monitoring by regulatory and supervisory authorities were highlighted. It was also evident that there was a limit to what the regulator could do and that expertise was lacking in certain areas – expertise which could only be provided by the external auditor. There was growing realisation that more reliance would have to be placed on the information and data provided by external auditors.

In considering the role of the external auditor in the banking supervisory and regulatory process, the first part of this paper looks at what constitutes regulatory capture and its origins. The paper then considers one of the basis of the validity of the claim namely, global developments which have taken place prior to the introduction of the present regulator and why a new regulator was introduced. As mentioned earlier, the type of regulator can contribute to knowledge of how the external auditor can assist the regulator. Under the review of the literature, which constitutes the second part of this paper, the rationale for regulation will then be discussed. Considering the rationale for regulation would also require an extensive examination of the reasons for regulation and the objectives of regulation. These various components cannot be treated in isolation when discussing the rationale for regulation. The literature review then considers reasons prompting a regulatory response – which should be distinguished from reasons for carrying out financial regulation. The paper will then show how a single regulator can fulfil its aims of being sufficiently accountable to industry : the purpose of accountability being one of the reasons why the single regulator was introduced. Certain jurisdictions will be considered - with Germany being the focus. The third section of the paper will then go on to consider certain accounting standards which govern the auditor's role and responsibilities in banking regulation and supervision. From these standards, the role of the external auditor will be highlighted and it will be shown that the external auditor does contribute immensely to the regulatory and supervisory process.

An analysis of UK banking regulation (developments, rationale for regulation, reasons prompting a regulatory change) and accounting/auditing standards provides a means whereby an assessment can be made as to whether the claim that the external auditor can help the regulator avoid regulatory capture is valid. This paper also considers what circumstances could render the external auditor prone to the same fate as the regulator – that is, circumstances which could render the external auditor incapable of performing his duties. In these circumstances, the role of the external auditor could be questioned. A detailed analysis of conflicting claims as to whether the external auditor has a role to play in banking regulation and supervision is beyond the scope of this paper. Consideration of factors affecting an auditor's independence and objectivity will however be considered – the role of an external auditor requiring an independent and objective mind. Despite these factors, it will be shown that an external auditor has a role to play in banking regulation and supervision.

Regulatory capture

Capture can be referred to as behaviours, active and passive, by responsible authorities, whose behaviours act to protect the same illegal, unethical, immoral or anti-public interest practices that those authorities are supposed to be 'policing'.[2] The theory of regulatory capture was introduced by Richard Posner, who argued that 'regulation is not about the public interest at all, but is a process, by which interest groups seek to promote their private interest ... Over time, regulatory agencies come to be dominated by the industries regulated.'

Briody and Prenzler (1998) attributed the occurrence of regulatory capture to either 'systemic capture' (procuration of an entire regulatory system by the regulated industry) or 'undue influence' (personnel exchange, identification with values through frequent contact, direct corruption). According to McMahon[3], at a first level of capture, the regulator allows the regulated to breach the law, ethic, good practice rule, moral principal or public interest duty that the regulator is responsible for upholding. At a second level, the regulator assists the regulated to avoid the regulatory consequences after the fact. At a deepest level of development, the 'capture' is so complete that the regulator may assist the regulated to defeat the regulatory regime before the fact.

Regulation theories

– Responsive Regulation : According to L Hill and L Stewart [4], courts need to be aware that their wide powers of review can have restrictive effects on the interpretation and enforcement of Parliamentary Acts and ability to support responsive strategies. This illustrates the role of courts in effective implementation and enforcement of national laws including effective implementation of self-regulation. The "Enforced Self Regulation Model" is a form of responsive regulation and this model will be discussed under the heading "The need for sufficient accountability"(page 11 of this paper). The role of external auditors in the regulatory process will very much depend on their ability to regulate themselves – which depends on effective law enforcement procedures.

- The Public interest theory of regulation : According to this theory, regulation is seen as catering for the interests of the public.
- The Private interest theory of regulation : Parties affected by regulation under this theory, try to influence such regulations in such a way that it gives them favorable outcomes. The private interest theory is a form of regulatory capture theory as the private interests of those being regulated overwhelm those interests of the public. In the accountancy profession, the Accounting Standards Board not only issues standards but is self-regulated. Under the "Enforced Self- Regulation Model" - to be dealt with under the literature review, a solution whereby self-regulation could foster accountability and still avoid regulatory capture - provided there were public interest groups involved, is illustrated by Grabowsky and Braithwaite.

Developments in the UK banking sector

The Bank of England Act 1946 had brought about significant changes to the status of the Bank of England through bringing the Bank under public control and by transferring capital it held to the Treasury. Following a spate of bank failures and institutional collapses: Johnson Matthey Bankers (JMB; 1984), Bank of Credit and Commerce International (BCCI; 1991) and Barings (Britain's oldest merchant bank; 1995), calls were made in favour of regulation (be it banking, investment, or insurance) to be undertaken by a single regulator. Other developments which have shaped the banking regulatory regime over the years include changes in financial services business: products being harder to categorise as banking, investment or insurance products; advances in technology and communications and globalisation. International developments have also played an important part in shaping the banking regulatory regime-especially with the UK's membership of the European Community and the harmonisation of the regulatory approach – with the First Banking Co-ordination Directive being introduced in 1977.

Prior to the Banking Act 1979, there was no statutory requirement that a bank or any similar deposit taking institution be authorised to accept deposits or undertake banking business in the UK. The Banking Act 1979 introduced a two-tier system of authorisation which delineated recognised banks from licensed institutions. Recognised banks were given the status based on track-record and standing and were not subject to as much statutory requirements as licensed deposit-takers.

The collapse of JMB, a member of the gold-bullion markets in 1984, led to review of the regulatory regime for banks. The root cause of the problem had been one of poor systems and controls. JMB was authorised under the 1979 Banking Act as a "recognised bank". Its collapse highlighted the deficiencies of the Banking Act 1979, namely that "recognised banks" were not immune from bank failures and also the problems of making a distinction between recognised banks and licensed deposit takers. The Leigh-Pemberton Committee was set up after a meeting between the Governor of the Bank of England and the Chancellor of the Exchequer, to consider the system for supervising banks.

The result was the Banking Act 1987 which replaced the two-tier system of regulation and encouraged increased co-operation between supervisors and auditors. The Banking Act 1987 chapter 22, Part 1 section 1(1) gave to the Bank of England powers and the duty generally to supervise banks – in particular, "institutions authorised to accept deposits". Under the Banking Act 1979, the term "recognised banks" had been used instead of "authorised institutions". Section 247(3)(c) of the Banking Act 1987 states that the words "a recognised bank or licensed Schedule 6 institution within the meaning of the Banking Act 1979", shall be substituted with the words "an authorised institution". Other sections of the Banking Act 1979 were also to substitute the words "a recognised bank", wherever they occurred, with the words "an authorised institution". According to section 744 of the Banking Act 1987, the definition of "recognised banks" was to be omitted and an "authorised institution" to be defined as a company which is an institution under the Banking Act 1987. The Bank of England Act 1998 Act unified regulation in the financial services industry-with the FSA being an amalgamation of pre-existing regulators and processes.

Prior to the Chancellor's announcement in 1997, in which the Chancellor of the Exchequer made a surprising revelation to transfer banking supervision from the Bank of England to the Securities and Investments Board (now the FSA), the system operating then consisted of a two-tier system which split responsibility between the SIB (Securities Investment Board)and the self-regulating organisations, together with the recognised professional bodies. According to the Chancellor's announcement, the division between the SIB, Self-Regulating Organisations (SROs) and Recognised Professional Bodies (RPBs), was inefficient and confusing for investors and also lacked accountability and clear allocation of responsibilities.[5] The source of the problems was related to the Financial Services Act 1986.[6] Under the Act, the SIB set the overall framework of regulation but did not itself act as the direct regulator of most investment firms. That function was performed by the second tier regulators - the Self Regulating Organisations (SROs) being the most prominent groups.[7] There were consistent concerns about the effectiveness of the SROs' efforts to prevent fraud and mis-conduct.[8] The Financial Services and Markets Act 2000 (FSMA) has replaced the Financial Services Act 1986, providing strong accountability mechanisms in response to the lack of accountability provided by the Financial Services Act 1986.

B. Review of the Literature and analysis of some developments in certain jurisdictions.

THE RATIONALE FOR REGULATION

Why is regulation carried out?

The rationale for financial regulation is an embodiment of two issues namely:[1]

- The problem of systemic risk : There being compelling evidence that a stable financial system provides conducive environment for efficient allocation of resources which in turn encourages economic growth[2].
- The problem of asymmetric information whereby certain information is known to some people but not to others[3]. Without regulation which gives consumers some independent assurance about the terms on which their contracts are offered, quality of advice received etc, saving and investment is discouraged resulting to damaging economic consequences.[4] In addition, healthy competition will be fostered through consumer education and disclosure of information on charges and other important characteristics of financial products.[5]

A distinction has been made by Llewellyn[9] between the objectives of regulation and supervision (the outcome regulation is trying to achieve); the rationale for regulation (why regulation is necessary if the objectives are to be achieved) and the reasons for regulation (why in practice regulation takes place). As a result, even though this paper will focus, amongst other issues on the rationale for a single regulator, it

1 Speech by Howard Davies, former chairman , Financial Services Authority "Building the FSA – Progress to date and priorities ahead" Wednesday 30 September 1998. Also see www.fsa.gov.uk
2 ibid
3 ibid
4 ibid
5 ibid

will investigate the reasons for a change to a single regulator (the FSA) and demonstrate how the objectives of the FSA can be achieved through a consideration of these reasons.

The three core objectives of financial regulation and supervision as suggested by Llewellyn are :[10]

- To sustain system stability,
- To maintain the safety and soundness of financial institutes, and
- To protect the consumer.

These are similar to the FSA's objectives as set out in the Financial Services and Markets Act 2000 sections 3-6. The cornerstone of the Act is the statement of regulatory objectives.[11] The regulatory objectives are: maintaining confidence in the financial system, promoting public understanding of the financial system, securing the appropriate degree of protection for consumers and reducing financial crime.

REASONS PROMPTING A REGULATORY CHANGE

Reasons prompting regulatory change, for example the adoption of a single regulator model, relate not just to inefficiency, lack of accountability and changing financial markets but also to harmonization and convergence and bank collapses. These reasons are usually interlinked. The origins of international regulatory convergence process can be traced back to a sequence of bank crises namely, the collapses of Bankhaus Herstatt in Germany, Franklin National Bank in the US, the secondary banking crisis in the UK and the collapse of Banco Ambrosiano in Italy in the early 1980s.[12]

These reasons will now be considered.

(i)Developments in financial markets:

As markets have liberalised and traditional banking business has become less profitable, the line between banking and other financial services is becoming less and less distinguishable. As noted by Vieten[13], there are many reasons as to why a regulatory response is required. The Big Bang focussed on the pace of change in the financial services industry and the differences between the environment in which many regulatory systems came into being and that in which they are currently working.[14]

As a result of globalisation, there is now need for all regulators to take account of the whole of a group's activities in assessing the risk faced by the institutions they authorised. This was emphasised in the *Barings* Case where the collapse of the group was due to malpractices in a single subsidiary. The issue of group structures was also highlighted in the *BCCI* Case.

Thirty years ago, financial markets were more distinguishable: there was clearer distinction between commercial banks and securities firms. There was also a further distinction between institutions which catered for wholesale customers like merchant banks and those which catered for retail markets like commercial banks.[15] Supervision focussed then on the activities of the commercial banks rather than securities firms. As deregulation has opened up financial markets to competition from both domestic and foreign institutions, such previous distinctions have become blurred. Deregulation has also promoted the cross-border flow of capital and attracted investors to seek rewards in overseas markets.[16]

Improvements in information technology have also played a crucial role in encouraging both trading of financial instruments across national boundaries and also development of new products including derivative instruments.[17] Key difficulties however relate to identifying and quantifying the risks associated with holding such financial instruments.[18]

(ii) Bank Collapses

The collapse of *JMB, BCCI and Barings* triggered a regulatory response. However, it is also helpful to consider the causes of these collapses in evaluating the proper remedies for those collapses. Some causes may not necessarily have warranted the creation of a single regulator. A specialist regulator may have failed to prevent some failures – not because it is incapable of doing so or not because it is insufficiently equipped to do so, but because of the style of supervision adopted by such regulator. In other words, a change in style of supervision may be all that was needed to remedy the regulatory problems encountered by the Bank of England. Where lack of sufficient expertise about other sectors (insurance, investment or other sectors) contributed to inability to supervise efficiently, then that could warrant the creation of a "mega" regulator such as the FSA. In this case, the expertise from different required sectors could be enhanced and combined more efficiently.

(iii)International and European Regulatory Convergence Processes

Vieten notes three main factors driving the harmonization of banking supervision in Britain and Germany namely:[19] agreements of the Basle Committee, banking law directives issued by the European Union and perceived competitive pressure to conform to internationally accepted market principles. As also stated by Vieten, harmonization initiatives do not necessarily indicate convergence of banking supervision as individual countries integrate the capital adequacy ratio into their regulatory systems in different ways.[20] In certain cases such as new rules being drafted on capital adequacy for banks, there is indeed a limit to the usefulness of convergence – as factors affecting such rules may vary from country to country.

In response to the Bankhaus Herstatt collapse, an *adhoc* committee, the Committee on Banking Regulation and Supervisory Practices came into being.[21] This consisted of governors of the central banks of the Group of Ten ("G-10") countries and Switzerland and was formed at the end of 1974.[22] The Committee came to be known as the "Basle Committee". The purpose of the Basle Committee is to provide a means whereby study of international aspects of prudential regulation and discussion of issues could be undertaken between participating national authorities.[23] This was aimed at elaborating common principles related to strengthening bank supervision and harmonising prudential standards .

Three elements are essential to convergence.[24] These are: a common definition of capital, a common framework for measuring capital adequacy and a common minimum standard. Over the years the work of the Basle Committee has extended to cover non-credit risks undertaken by banks.[25] This was in response to the development in the global markets – with the advent of the growth of financial conglomerates .

As a result of global changes and development in global financial markets and activities of banks, the scope of bank supervision has also developed. Two areas relevant to this section are initiatives put forward by the Basle Committee on Banking Supervision and the European Union and domestic developments in the UK.[26] With respect to the Basle Committee and the European Union, directives issued must be taken into consideration but Basle guidelines are not legally binding in the national states concerned.

Such environmental and global changes discussed above (which will be classified as external factors) and which may affect industry structure should be distinguished from internal factors (for example, lack of proper implementation of internal controls) which result from within a particular company - in considering an appropriate regulatory response.

iv) The system prevailing prior to the introduction of the FSA was not delivering the standards of investor protection or supervision which both the industry and public deserved. This reason would also naturally incorporate failures to achieve other objectives of financial regulation such as sustaining system stability and maintaining the safety and soundness of financial institutes.[27]

v) The distinction between different types of financial institutions and the products which they offered was getting increasingly blurred : this called for a move from supervision which was based on institutional types.

The increasingly global nature of the financial services sector also called for a change.

vii) Consolidated prudential supervision of multi-functional financial groups would provide an efficient way of managing risks related to different financial activities.[28]

viii) The extent to which financial products and contracts are significantly different from general goods and services (these general goods and services not being regulated to the same degree as financial institutions).

ix) The transfer of bank supervision to the FSA may also avoid a situation where conflict of interest occurs.[29] Proponents of a transfer to the FSA may argue in relation to a conflict of interest, that a situation whereby the central bank acts as lender of last resort and sets monetary policies as well as supervisor, may give rise to conflict of interest.[30]

However, Briault (insert endnote) asserts that arguments against combining responsibilities for monetary policy and banking supervision in a single institution are unsustainable and that the real issue is whether the synergies in combining banking regulation with monetary policy are greater or less than the alternative synergies arising from the creation of a single financial services regulator. He goes on to say that there may however be justification in some developing and transition countries, where the central bank stands (almost) alone as an institution with independence from political interference and also has the resources to recruit and retain high calibre staff. He adds that in those circumstances, the effectiveness of financial services regulation could be compromised if this function were removed from the central bank.

Briault does not argue for or against whether one institution should perform both functions of monetary policy and bank supervision. He is stating that real issue does not relate to whether one institution performs one or both functions but about weighing benefits of a single regulator against benefits of both functions being entrusted to one authority.

I partly agree with Briault. Weighing the benefits of having a single regulator against benefits of functions of supervision and monetary policy setting being entrusted to one authority would seem to imply that the less favorable option should be discarded. However both options can still be combined as central banks and single regulators have their unique beneficial attributes. If there are more benefits than disadvantages in having a single institution (the central bank), perform both functions (considering the jurisdiction's political and other internal structures), then the single regulator should still carry out supervisory functions – however this should be done in close collaboration with the central bank. Benefits in having a single regulator amongst other things, includes better management of risks generated by various types of businesses and their associations. This is an attribute which cannot be provided by the central bank – whether or not it performs just the sole function of monetary policy setting or additional supervisory responsibilities. Likewise the knowledge and expertise of the central bank is something which cannot be generated by a single regulator. The main issue should be whether a particular jurisdiction benefits more or less from having a single regulator in comparison to having a functional regulator. In my opinion, the function of monetary policy setting is one which should be carried out by the central bank alone. In addition, the question of achieveing the right design of regulatory structure of a particular jurisdiction will need to be examined against the background of a particular financial structure of each country rather than being generalised.[6]

There are many reasons in favour of the central bank also acting as supervisor[7] and these are as follows : That the central bank must have concern for the efficient working of the payments system and that as a result, it should also supervise and regulate at least the main money-market commercial banks at the heart of the system; that any rescue or liquidity crises will usually require quick injection of cash-which can only be done by the central bank. For this reason, it is argued that the central bank and supervisory body work closely together and that this can best be achieved through internalising the supervisory body within the central bank; and that separation would involve wasteful duplication as there is bound to be a lot of overlap between areas of interest of and information required by and accessible to both the supervisor and the central bank.

Arguments for separation include : Where government financing is required for any large rescue, politicians and the Ministry of Finance are likely to be involved. For this reason, it is important for the central bank to become more independent in the conduct of monetary policy and less politically involved in its supervisory role; that bank failures affect credibility and the central bank requires credibility in conducting its monetary policies; and where concerns for the micro-level health and stability of parts of the banking system might affect the aim of the central bank's conduct of monetary macro-policy – that is, where there is conflict of interest between the combination of monetary and regulatory function.

x) Unified financial services regulation may also reduce duplication and over-regulation.

By fulfilling its purpose and providing justification for these reasons, the FSA will be able to achieve its regulatory objectives namely, maintaining confidence in the financial system, promoting public understanding of the financial system, securing the appropriate degree of protection for consumers and reducing financial crime. According to the FSA Annual Report 2004/05, sector teams within the FSA have been pursuing the objectives of the FSA. In relation to consumers, the launch of "FSA Connection" detailing

6 Also see C Goodhart and D Schoenmaker ' Institutional Separation Between Supervisory and Monetary Agencies' (Financial Markets Group Special Papers 1992) 161

7 C Goodhart and D.Schoenmaker ' Institutional Separation Between Supervisory and Monetary Agencies ' (Financial Markets Group Special Papers 1992)140-141; CAE Goodhart *The Emerging Framework of Financial Regulation* (1998) 249

regulatory issues affecting consumers, reaching over 3000 advisers and advice agencies has taken place. In view of the difficulty of quantifying benefits and costs of regulation, the FSA has been working with the Henley Centre to establish outcomes which are capable of being measured in an open and transparent way – in order to demonstrate the impact of regulation on markets and consumers. The Financial Services Practitioner and the Consumer Panels also play important roles in the accountability and regulatory framework established under the FSMA 2000.

In relation to financial crime, publication of a report on "Countering Financial Crime Risks in Information Security" was also carried out. The fight against financial crime continues to focus on the FSA's aims : namely the monitoring of standards of systems and controls in the firms regulated by the FSA, increasing the FSA's understanding of fraud risks across the financial sector and working closely with other authorities, in particular the Home Office and law enforcement. In relation to financial stability, research into the use of stress by major firms (as part of their risk management framework) has been undertaken and results are due shortly. In addition, the FSA has taken steps to be more open about risk considerations across different number of firms and has been putting information on their website about their response to these kinds of risks.

Llewellyn has also given reasons in support of a unified regulator.[31] These include the introduction of economies of scale – especially with regards to skills provided by employees, the avoidance of problems of inconsistencies, duplication, overlap and gaps which could arise where a system of several agencies existed, the rational utilization of scarce human resources and expertise. Other reasons which have influenced countries to set up unified regulators, as stated by Llewellyn include[32] the growth of financial innovation, the complexity and extensiveness of objectives behind regulation in some countries and the increasing internationalisation of financial operations. However he also highlights possible shortcomings[33] such as the erosion of functional distinctions between financial institutions, lack of clear focus on the objectives and rationale of regulation (not making necessary differentiations between different types of institutions and businesses such as wholesale an retail business), possibilities of cultural conflict since regulators come from different sector backgrounds, possibilities of creating an excessively bureaucratic single regulator with too much power. There is also the fear that consumers will no longer take responsibilities for their actions – thereby generating the moral hazard problem (people believe that the government is keeping an eye on the behaviour of the regulated business and so not monitoring as they should).

Consumers are not adequately equipped with sufficient means to judge the safety and soundness of the financial system. This is the main reason why prudential regulation is necessary – because of imperfect consumer information, agency problems associated with the nature of financial institutions' business and because the actions of a financial firm after consumers have dealt with it affects the value of their interests in that firm.[34] However, as stated above, the FSA has provided mechanisms to deal with this - including the Financial Services Practitioner and the Consumer Panels which play important roles in the accountability and regulatory framework established under the FSMA 2000. The Financial Services Consumer Panel advises the FSA on all aspects of its work – at the same time monitoring its effectiveness from a consumer's perspective.[35]

The Financial Services Practitioner Panel (‘the Panel’) was set up by the FSA in 1998. Subsequently the FSMA 2000 established the Panel as a statutory body alongside the Consumer Panel.[36] The Consumer Panel represents the interests of consumers to the FSA. This was in recognition of the important role of both Panels in the accountability and regulatory framework established under the Act. Both Practitioner and Consumer Panels became statutory on 18 June 2001.

Summary

Reasons for adopting a single regulator have been considered. As well as reflecting the financial services markets and reducing duplications and inconsistencies, a single regulator presents opportunities for developing a rational and coherent regulatory system.[37] A single complaints handling and Ombudsman system has been set up as well as a Financial Services Compensation Scheme.[38] This would help avoid inconsistencies and fill regulatory gaps which as a result, would give rise to benefits of economies of scale.[39] As regulated firms would be dealing with one regulator, regulatory costs associated with authorisation procedures, monitoring and disciplinary procedures would also be reduced.[40] Concerns associated with a single regulator are inherent in its enormous size and monopoly position.[41] Lack of regulatory competition may also hinder innovation in regulatory techniques.[42] Bank collapses triggered the creation of a single regulator. However, has the regulatory response to regulatory problems and occurring events been appropriate?

What kind of response could be anticipated and how could that kind of response be achieved? In order to answer the first of these questions, one needs to analyse the regulatory problems and events concerned and the lessons to be learned from the bank collapses. In response to the latter question, a consideration of how a good regulatory policy can be achieved is required.

In assessing the role of the external auditor in banking regulation and supervision, it is not only important to look at the type of regulator. The system of supervision is also important. According to the Core Principles (Basel Core Principles) for effective Banking Supervision 1997, an effective banking supervisory system should consist of some kind of both “on-site” and “off-site” supervision. 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. The system of supervision under the Bank of England was discretionary based. It was based on an informal system of supervision and on trust. Following the collapse of BCCI, Lord Justice Bingham made recommendations that included the need to adopt a more rule-based or inspection based approach to supervision. Although the Bingham report did not suggest a move towards the US supervisory system which relies on on-site examinations by independent inspectors, rather than on bank auditors, it was asserted that the Bank of England had relied **excessively** on BCCI’s auditors.

THE NEED FOR SUFFICIENT ACCOUNTABILITY

Prior to the introduction of the FSA , **the Financial Services Authority**, it was believed that the system that existed in the UK lacked transparency and sufficient accountability partly as a result of its fragmented regulatory structure.[43] Even though the FSA is independent of Government, it is still accountable not only to Government but also to Parliament, the industry and consumers. The Financial Services and Markets Act 2000 establishes eight main accountability mechanisms for the FSA.[44] However, many questions and concerns have been raised about accountability in relation to single regulators because of the concentration of powers inherent in the all encompassing nature of their role:[45] **Can a single regulator be made sufficiently accountable to industry whilst avoiding regulatory capture?**

The Enforced Self-Regulation Model could help a single regulator to achieve this. As mentioned previously, regulatory capture can generally be described as the capture of a regulator by the regulated. Under the Enforced Self-Regulation Model, companies and firms (the regulated) are given the responsibility of regulating themselves whilst the regulator oversees these firms. Grabosky and Braithwaite[46] illustrate situations whereby capture is more likely to occur. Characteristics include where: only one industry is being regulated, where the regulator is part of a larger organisation, where there is conflict between regulator and the regulated, where regular contact occurs between the regulator and the regulated and/or where a regular exchange of personnel occurs between the regulator and the regulated. In the first of these characteristics, capture is unlikely to occur with the FSA as it regulates more than one industry. These industries include the banking, insurance, investment industries, building societies, credit unions, pension funds, markets and exchanges. Whether the FSA is part of a larger organisation is debatable. Whilst functioning under a truly integrated approach, for example when adopting its new single risk-based integrated approach across all regulated sectors, the FSA could be referred to as a regulator acting on its own and not as part of a larger organisation. However, where it acts under the capacity of a lead regulator – as it does under the lead regulator model, this would present a situation whereby it could be classed as part of a larger organisation. Other characteristics given whereby capture is more likely to occur can be avoided much more easily by the FSA through clear delegation and delineation of responsibilities. A variant of the characteristics given by Grabosky and Braithwaite could also exist in an individual situation. For example, where more than one industry is being regulated, there could also be conflict between the regulator and the regulated – in which case, capture is also likely to occur.

It is argued that direct government regulation provides disincentives for nominated accountability[47] - because nominated accountability ‘puts heads on the prosecutor’s chopping block’. However, direct government regulation also promotes accountability as it is easier to identify who is responsible for any fault committed, hence no “passing of the buck”. Apart from the Enforced Self-Regulation Model, the regulator could also employ the services of a “middle-man” to help carry out the regulation of firms. This would help prevent the regulator from getting too involved and influenced by the activities of the firms being regulated whilst ensuring that the middleman provides some oversight. It is still vital for the regulator to be involved in the oversight process, albeit to a lesser degree than would be if the middleman were not involved. This research amongst other objectives, aims to explore how the FSA as a regulator, could benefit from the expertise of the external auditor as a middleman, to avoid regulatory capture.

The less the number of middlemen involved, the more accountability that can be ensured. However even with the involvement of more middlemen, accountability can still be ensured as long as there is clear delegation of responsibilities but it is more expensive and time consuming. One significant advantage of involving more middlemen is that there is more segregation of duties – hence less likelihood of one sole department abusing a system without being detected. Even though some would argue that the more middlemen you have, the more likelihood there is of conflict of interests, this is not always necessarily so. If the law and goals involved are clearly defined and each department knows what they are aiming for and there is clear coordination and adequate supervision, adequate oversight by the regulator, any potential conflict of interest should and could be significantly minimised. In addition, focus on punitive measures need not always be on the regulated alone. The regulator and middlemen involved should account for inadequate supervision or lack of supervision. Enforced self-regulation provides incentives for nominated accountability because corporations that cannot demonstrate that they are conducting their own executions would be singled out for inquisition.[48] Enforced self-regulation represents an extension and individualization of co-regulation.[49] Co-regulation is distinguished from enforced self-regulation to mean industry-association self-regulation with some oversight and/or ratification by government.[50] Co-regulation could also be carried out by the external auditor in collaboration with certain public interest groups.

Using the Enforced Self-Regulation Model, the greater the level/amount of regulation carried out by government/state, the lesser the punishment that would be imposed on any company/firm in the event that non-compliance were discovered. Another model of Enforced Self-Regulation which could have been successful but which has to be discounted is that whereby the punitive measures imposed are directly proportional to the level of non-compliance. As a result, the greater the level of non -compliance, the greater the sanctions imposed. The failure of this model lies in the fact that there’s potential for moral hazard as fraud or non-compliance perpetrators are encouraged to take more risk and commit more crimes (exploiting the system more often) as the punitive measures are bearable – provided they committed it “discretely”. The punitive measures could even be avoided or escapable – as a result, more offenders would be encouraged to take the risk as they would not have much to lose – even if they were caught.

However, a combination of these so-called “minor offences” have the potential to create even more serious consequences than the “major offences”. To illustrate this, an offender could commit a series of fraud involving insignificant sums of money in separate individual circumstances. When these sums add up, their effect could be greater than what would occur if a single significant sum of money were involved.

Styles of/ forms of integrated regulation and supervision in other jurisdictions

The growth of financial conglomerates has led to the adoption of the single regulator model in many financial markets. Bringing together the regulation of different types of financial businesses was pioneered by Scandinavia and is occurring in many parts of the world, especially in the Far East. The big exception is the US whilst in Australia, there is division between prudential and conduct of business regulation – as well as the division between different sectors.[51] Although unified financial services supervision has been adopted differently in many countries, its application has varied from country to country and there is no single proper way of introducing or implementing unified financial services supervision.[52]

Financial Regulation and Supervision in Germany

As well as the UK, Germany has also considered integrated financial supervision as the best response to the growth of financial conglomerates. In her paper, Tatyana Filipova[53] concludes that the German *Gesetz ueber die integrierte Finanzaufsicht* (the Law on Integrated Financial Services Supervision in Germany) has not managed so far to realise the alleged benefits of integrated financial supervision. In contrast to the UK where major legislative changes occurred, the substantive law was not amended in Germany to utilise the integrated supervisory structure.[54]

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).

Central to the *Gesetz ueber die integrierte Finanzaufsicht* is the *Gesetz ueber die Bundesanstalt fuerFinanzdienstleistungsaufsicht* (FINDAG) – Law on the Federal Financial Supervisory Authority.[55] FINDAG established a single authority – the Federal Financial Supervisory Authority (Bundesanstalt fuer

Finanzdienstleistungsaufsicht, BaFin) which acts as supervisor over all financial services providers.[56]

Banking supervision is carried out by the Federal Financial Supervisory Authority, the *Bundesanstalt fuer Finanzdienstleistungsaufsicht* – BaFin (previously banking supervision had been carried out by the Federal Banking Supervisory Office). BaFin was set up pursuant to the law on Integrated Financial Services Supervision in Germany.[57] This law was adopted by Parliament on the 22nd April 2002 and on the 1st May 2002, BaFin was formally established.[58] BaFin is a federal institution and also part of the institutions which operate under the Federal Ministry of Finance.

Section 6 of the Banking Act assigns the central role in banking supervision to the Federal Financial Supervisory Authority (BaFin) whilst section 7 states the collaboration between BaFin and the Deutsche Bundesbank (the German Central Bank) in the supervision of banks.

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.[59] Participation of the Bundesbank was considered necessary since the then Federal Banking Supervisory Office had no substructure of its own.[60] 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 Germany.[61]

There is clear division of functions between the Federal Financial Supervisory Office and the Bundesbank in the area of banking supervision[62]. 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…-[63]

The BaFin has 3 main objectives :[64]

- 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.[65]

The development of banking supervision after the Second World War, Basic features of the Banking Act will be considered in later paper.

According to its draft legislation to create an integrated financial services regulator, Germany considered integrated financial services supervision as the best was of dealing with dynamic changes in the financial markets. The *Gesetz ueber die intergrierte Finanzaufsicht* does not define a set of objectives that the Federal Financial Supervisory Authority should pursue during the performance of its functions[66] - the respective laws for banking, insurance and securities supervision being defined by different objectives for the different financial sectors.[67] The *Gesetz ueber die integrierte Finanzaufsicht* also does not assign new responsibilities in contrast to the FSA which new additional supervisory responsibilities. It merely transfers the responsibilities of the previous specialist supervisors – the Federal Banking Supervisory Authority, the Federal Insurance Supervisory Authority and the Supervisory Office for Securities.

In contrast to the FSA, the BaFin doesn't have rule-making powers to converge the sectoral supervisory practices.[68] Different approaches to regulation and supervision with respect to banks, securities and insurance companies exist in Germany and the poor definition of the objectives relating to these industries may provide little guidance to the BaFin when the different supervisory objectives come into conflict as the current legislation does not provide a way of deciding on the supremacy of the different supervisory objectives.[69]

In contrast to the UK where the Bank of England is not involved in supervision of financial institutions, the German Central Bank , the Deutsche Bundesbank assists BaFin in exercising supervision over credit and financial institutions. The Bundesbank is in charge of ongoing monitoring which includes evaluation of documents submitted by institutions, auditors reports pursuant to KWG section 26 (*Gesetz ueber das Kreditwesen*, Banking Act) and the annual financial statements.[70] The Bundesbank performs , evaluates audits of banking operations with the aim of assessing the adequacy of institutions'capital and risk management procedures as well as appraising audit findings and it may also be entrusted by BaFin with the task of performing audits at the credit and financial institutions.[71]

The Central Bank's Role in maintaining stability.

As well as being involved in the supervisory process, the Bundesbank is also involved in matters relating to supervisory policy-making. As a member of the Financial Markets Regulatory Forum, it is acknowledged as an authority that together with BaFin is responsible for the stability of the financial system.[72]

From the points mentioned so far, it could be argued that the reorganisation of the legal framework carried out in the UK is a better way of implementing integrated financial supervision. On the other hand, the involvement of the central bank in supervision, as is the case in Germany, could also be a better way of implementing integrated financial supervision. However, even though the Bank of England is not involved in supervision (as is the case in Germany), the FSA continues to work closely in exchanging information with the Bank of England and the Treasury under the 1997 Memorandum of Understanding. In addition, the close cooperation between the FSA and the Bank of England is strengthened by the cross-membership of the chairman of the FSA as a member of the Court of the Bank of England and by the deputy Governor of the Bank of England being a member of the FSA Board.[73]

Briault[74] also concludes that experience in the UK since the creation of the FSA has demonstrated that information can and does flow effectively in both directions between a central bank and a separate integrated financial services regulator and that the Bank of England and the FSA share and discuss at all levels a large volume of information.

A more critical analysis of the legal framework of the British and German systems, the relationship between the central banks and supervisory authorities and other related factors will be required before an assessment can be concluded.

Financial Regulation and Supervision in Italy

One of the foremost debates focussed around Italian regulation at present is related to the issue of the best regulatory structure. Banking regulation and supervision in Italy has always been the function of the central bank. Even though the 1936 Banking Law 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.[75] 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. It 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 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.[76] Separate supervisors regulate and supervise the insurance and pensions industries.

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. The Amato Law (218/1990) formed the basis of the legal framework and paved way for the privatisation of the Italian public banking system. 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.

The North South Divide

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. 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.[77] 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 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 Napoli'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.

Financial Regulation and Supervision in the US

Even though there is now an increasing trend towards the adoption of a single consolidated financial regulator, the US system of financial regulation is based on a functional regulatory framework. In his speech, Ethiopis Tafara[78] stated that whilst there were advantages with consolidated financial regulation, the advantages inherent in functional regulation (the system adopted by the US) should not be ignored. He also mentioned that consolidated regulation was based on unproven assumptions.

Advantages of functional regulation

Tafara states that insurance, banking and securities regulators all have an interest in prudential regulation – maintaining the health and soundness of financial firms and that all functional regulators have an interest in enforcing the law. He goes on to add that the differences between the functional regulators include the fact that 'consumer protection' and systemic stability for insurance and banking regulators mean that enforcement activities were carried out more 'discreetly' and this was as a result of banking and insurance regulators' concerns that public enforcement activities would lead depositors or consumers to lose faith in the firm involved – thereby leading to a run on the bank. In contrast securities regulators tend to have aggressive approach in public enforcement procedures and believe that public enforcement actions are necessary to deter fraud and reassure investors about the integrity of the system. He also mentions that in the US, since bank deposits were frequently insured by the government, bank regulators were very concerned about moral hazard problems – that banks would make reckless decisions in hopes of getting higher returns, knowing that depositor losses would be borne by the government. With investors in securities markets, there is no such investor insurance scheme and securities regulators emphasize disclosure rather than prudential regulation. Despite this statement, there is still confusion between the Securities Investor Protection Corporation (SIPC) and the FDIC. Insurance for investment fraud does not exist in the US – the SIPC is not the securities market equivalent of FDIC (Federal Deposit Insurance Corporation). Congress considered creating a Federal Broker Dealer Insurance Corporation but lawmakers widely concluded it would be inappropriate in the risk-based investment market place which is different from that of the banking world.[79] This approach by the US is to be contrasted with the Investor Compensation Directive which was modelled on the Deposit-Guarantee Schemes Directive (94/19/EC) which provided for the universal nature of banks and growth of financial conglomerates. The need for consistency between the Investor Compensation Directive and the Deposit Guarantee Schemes Directive – in the case of banks acting as investment firms, is highlighted.

As a result of the differences in priorities between bank, insurance and securities regulators, an advantage of functional regulation could be said to be that it takes into account the differences and needs of the various markets involved. In addition, even though banks place more emphasis on prudential supervision than securities markets, **both** banking and securities regulators still have an interest in prudential regulation. Sa`me thing applies to the issue of public enforcement activities. A system of functional regulators would definitely achieve a better policy objectives 'mix' than a situation where a consolidated regulator operated with one 'consolidated' objective for different financial sectors. The FSA has been able to avoid such a problem by operating according to a functional approach.

Areas for particular consideration

As part of its future work, the Consumer Panel seeks to[80] : Put the "service" back into financial services, encourage the FSA to improve its communication with consumers, assess (using a holistic rather than piecemeal approach) the FSA's effectiveness, weighing its impact from the consumer perspective, treat consumers fairly : this priority has always been supported – however, more focus will be placed on its implementation and evaluation, seeking to encourage European bodies and Commission to improve their dialogue with consumer representatives across the European Union.

Managing and controlling the risks inherent in a bank's operating activities

The role of the bank supervisor: How can risks be managed in a volatile environment? Instruments contributing to volatility within the financial environment should be regulated – especially when they constitute an amount in the region of billions of currency value. A study of the market impact of hedge funds and consideration of the FSA's regulatory approach has been undertaken and a paper will be published shortly.[81]

The FSA presently operates according to risk based regulation and resource allocation.[82] Alan Greenspan has recently stated[83] that hedge funds should not pose a threat to financial stability so long as lending banks managed their risk sensibly. It is difficult to see how banks can manage their risk when the root cause is not being dealt with – especially where the situation involves a rise in assets such as huge amounts unregulated hedge funds. If instruments such as hedge funds could lead to volatility, then they should fall under instruments to be regulated by the FSA.

As highlighted in the Barings Case, banks mainly fail due to management incompetence – which is in some cases, accelerated by poor controls. As such there are strong arguments for focus on bank supervision to be more on monitoring controls and procedures implemented by management and less focus on the traditional area of ensuring that adequate capital is being maintained – though both are important.[84]

International co-ordination of bank supervision

The BoBS report into the collapse of Barings Bank highlighted the need for closer cooperation between the Bank of England and other regulators both in the UK and overseas. The report welcomed the development of a formal Memoranda of Understanding between regulators internationally and further recommended the use of joint teams of supervisors to visit banks. The Memorandum of Understanding has helped to ensure timely and efficient coordination and allocation of work between the FSA, the Bank of England and the Court of the Bank of England with experience to date on information sharing showing that the arrangements will work effectively in the course of a crisis.[85] In addition to this, the FSA as a single financial services regulator should be able to provide better and quicker access to information about the overall position of a financial conglomerate in a situation of difficulty than might have been available in the past from multiple regulators responsible for individual firms within the conglomerate.[86]

FSA's work so far

The period from the 1st April 2004 to the 31st March 2005 saw particularly the review of 2 aspects of the FSA's performance. The first of these aspects was the examination of the costs imposed on the regulated – this being done jointly with the Practitioner Panel.[87] The second was the examination of the effectiveness and fairness of the FSA's enforcement process.

The FSA has so far managed to keep its costs under control.[88] According to an FSA comparative report of direct costs of regulation, the UK ranked second cheapest behind Sweden (another single regulator country) with US regulatory costs being 18 times those of the UK[89] However, there are concerns that the FSA has only achieved this because of regulated firms which have faced a sharp increase in compliance costs – with a larger proportion of these compliance costs being passed disproportionately to smaller firms.[90]

Hampton's recommendations relating to the advantages of integrated regulatory organisations and risk-based regulation have been embedded in the way the FSA operates.[91] Efforts have also been devoted to finding ways to restrict regulatory intervention to areas where no market solution is possible and where regulation has the potential to do good rather than harm.[92] In relation to consumer credit however, the Chairman had reservations about the wholesale transfer of such related responsibilities to the FSA.[93]

Concerns also remain over hedge funds – in which case the jurisdiction of the FSA is limited. The FSA does not authorise the funds and most of the administrators of these hedge funds are located offshore.[94]

At present, the main concern relating to the FSA relates to whether the FSA's human resources can attract and retain a sufficient number of well qualified staff because of the gap in pay levels between private and public sectors.[95]

As of now, the FSA regime doesn't exhibit signs of having been captured by industry.[96] There have been criticisms from industry that the FSA is too consumer-orientated and criticisms from consumer groups that the FSA is too pro-industry but it is naturally too early to draw conclusions as to whether the FSA has been successful or not. As regards economies of scale, it is difficult to say whether the FSA has been able to benefit since it took over supervision from the Bank of England. This is because of the difficulty in providing a precise comparison of costs, the impact of transitional costs in moving to a single regulator and the increased costs of the FSA as a result of its additional responsibilities under the FSMA.[97]

The FSA has been able to adopt a consistent , coherent and focussed approach across the financial services industry to cross-sector issues.[98] However there have also been arguments as to whether or not a single regulator can give a coherent and clear mandate.

In relation to its statutory objectives, the first objective, maintaining confidence in the UK financial system, is one which can be delivered effectively only in close collaboration with the Bank.[8] The framework for that collaboration has already been set out in a Memorandum of Understanding between the Treasury, the Bank and the FSA. [9]

In relation to its fourth objective, the reduction of financial crime, the FSA's rules require authorised firms to report "significant" fraud to the FSA.[10] The auditor also has to report directly to the FSA under ISA (UK and Ireland) 250 Section B. The auditor and the deposit taker have further reporting obligations under the Proceeds of Crime Act 2002 and the Money Laundering Regulations, 2003 (amended) to report suspicious offences of money laundering including those emanating from fraud and theft.[11]

In relation to the second and third objectives , the FSA needs to get closer to the market and consumers. From the Treasury Committee's First Report on Barings Bank and International Regulation, it was highlighted that the Bank of England, the FSA's predecessor, could not perform its main objective of protecting the financial system without assessment of the functionings of the firms in the market. Same applies to the FSA. In order to achieve its objectives to the financial system, public, market and consumers,

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8 See speech by Howard Davies, Chairman of the Financial Services Authority, Wednesday 30th September 1998, " Building the FSA, progress to date and priorities ahead".

9 ibid

10 SUP 15.3.17R.

11 See ISA (UK and Ireland) 240 : The auditor's responsibility to consider fraud in an audit of financial statements paragraphs 44 and 45

the FSA must get closer to the market and consumers.

This need to get closer to the market requires early warning indicators – indicators which the FSA's predecessor, the Bank of England could easily detect. So who could provide the answer to the gap left as a result of the Bank of England's reduced involvement in the banking supervisory process? The FSA in its proximity to the market and consumers would also need to be mindful of not getting 'captured' by those it is supposed to be regulating. The external auditor would seem to have a role in the banking regulatory process by

i) Acting as an intermediary in getting close to the market and consumers
ii) Helping the regulator avoid regulatory capture

C. HOW THE EXTERNAL AUDITOR FUNCTIONS AS A MIDDLEMAN/AN INTERMEDIARY IN THE REGULATORY AND SUPERVISORY PROCESS.

Statement of Auditing Standards (SAS) 620 Revised : The Auditor's Right and Duty To Report To Regulators in the Financial Sector

The International Standard on Auditing (ISA UK and Ireland) 250 sections A and B also respectively deal with consideration of laws and regulations in an audit of financial statements and the auditors' right and duty to report to regulators in the financial sector .

According to the Statement of Auditing Standards (SAS) 620 which replaced the original SAS issued in 1994, directors of regulated entities have primary responsibility for ensuring that all appropriate information is made available to regulators. Auditors' reports on records, systems and returns, regular meetings with directors and/or senior management supplemented by any inspection visits considered necessary by regulators should provide regulators with all the information they need to carry out their responsibilities. Through the auditor's involvement in the regulatory and supervisory process, the possibility of capture occurring could be reduced significantly as personnel exchange or frequent contact between the regulator and the regulated is reduced.

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.

Under the Financial Services and Markets Act 2000 (Communication by Auditors) Regulations 2001 (" the

2001 Regulations"), the auditor has duties under certain circumstances to make reports to the FSA[12]. The 2001 Regulations also do not require the auditor to perform any additonal work because of the the statutory duty nor is the auditor required to specifically look out for breaches of the requirements applicable to a certain authorised firm.[13]

Section 342 of the FSMA 2000 also [14]provides that no duty to which an auditor of an authorised firm is subject shall be contravened by communicating in good faith to the FSA information or an opinion on a matter that the auditor reasonably believes is relevant to any functions of the FSA.

Confidentiality

In accordance with SAS 620, auditors are entitled to communicate to regulators information or opinions in good faith about matters relating to business or affairs of the entity or any associated body. However, this relates to information and opinions obtained in their capacity as auditors. Auditors and regulators should be aware that confidential information obtained in other capacities may not be normally disclosed to another party.

Even though confidentiality is an implied term of auditors' contracts with authorised firms, section 343 of the FSMA states that an auditor of an entity closely linked to an authorised firm who is also the auditor of that authorised firm does not contravene that duty if he reports to the FSA information or his opinion, if he is acting in good faith and if he reasonably believes that the information or opinion is relevant to any function of the FSA.[15]

Statements of Auditing Standards (SAS) 120 Revised : Consideration of law and regulations

The revised Statement of Auditing Standards (SAS) 120 replaced the original SAS issued in 1995. According to the Auditing Practices Board, the purpose of this SAS is to establish standards and provide guidance on the auditor's responsibility to consider law and regulations in an audit of financial statements.

Responsibilities of the auditors

According to the Auditing Practices Board,[99] 'it is not the auditor's function to prevent non-compliance

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12 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

13 ibid

14 See ISA (UK and Ireland) 250 section B paragraph 82 of the Auditor's Right and Duty to Report to Regulators in the Financial Sector

15 See ISA (UK and Ireland) 250 section B paragraph 75 of the Auditor's Right and Duty to Report to Regulators in the Financial Sector

with law and regulations. The fact that an audit is carried out may, however, act as a deterrent.' An audit is not expected to detect **all** possible non-compliance with law and regulations. The responsibilities of auditors of private sector entities as regards law and regulations are similar to those of auditors of limited companies and other entities in the private sector.

Auditors should plan and perform their audit procedures, evaluate and report on the results thereof, recognising that non-compliance by the entity with law or regulations may materially affect the financial statements (SAS 120.1). This can be done through [100] : (a) obtaining a general understanding of the legal and regulatory framework applicable to the entity and the industry, and of the procedures followed in order to ensure compliance with that framework; (b) inspection of correspondence with relevant licensing or regulatory authorities; (c) making enquiries with directors as to whether they are aware of notice of any such possible instances of non-compliance with law and regulations; and (d) obtaining written confirmation from the directors that they have disclosed to the auditors all those events of which they are aware which involve possible non-compliance, together with the actual or contingent consequence which could arise there from.

Returning to the instances mentioned by Grabowsky and Braithwaite, as to where capture is more likely to occur, the Standards (SASs) could help prevent conflict between the regulator and the regulated as the external auditor's involvement in the regulatory and supervisory process, according to the SASs, presents a situation whereby the regulator becomes less involved – through the external auditor acting on behalf of the regulator. Hence there is likely to be less conflict between the regulator and the regulated. The possibility of regular contact between the regulator and the regulated is also less likely where the external auditor acts on behalf of the regulator. Where the regulator is part of a larger organisation, the external auditor could still help prevent regulatory capture. There are many advantages in having a single mega regulator which still maintains some form of "uniqueness" within the departments in its organisation. Uniqueness refers to individuality and even though retaining some individuality within the different industry sectors which make up a single regulator is contrary to the spirit of a truly integrated approach, it is practically difficult for all separate sectors to work under a common objective without taking into consideration differences relating to these sectors. Even in a truly integrated single regulator organisation, there is still likely to be conflict or clash between sectors due to different backgrounds or certain objectives which are difficult to reconcile in given circumstances. A truly integrated approach is however workable where clearly defined law exists to deal with potential conflicts, inconsistencies between different sectors – especially in matters relating to objectives. This is not particularly an area where an external auditor has much influence – the law makers are responsible for drafting clearly defined and unambiguous law. The external auditor's role is to work on behalf of the regulator, with the relevant department/s which make up the regulator and communicate with the regulated.

Procedures to be followed when possible non-compliance with law or regulations is discovered.

According to SAS 120.5, auditors should obtain an understanding of the nature of the act, the circumstances in which it occurred and sufficient other information to evaluate the possible effect on the financial statements when they become aware of information which indicates that non-compliance with law may exist.

They should then document their findings and subject to compliance with legislation relating to "tipping off" and any other requirement to report them direct to a third party, discuss them with the appropriate level of management (SAS 120.6).

Auditors should also consider the implications of suspected or actual non-compliance with law or regulations in relation to other aspects of the audit (SAS 120.7).

Reporting non-compliance with law or regulations

Action taken by auditors to report a suspected or actual non-compliance with law or regulations varies according to their statutory responsibilities. In accordance with SAS 120.8 and subject to compliance with legislation relating to "tipping-off" and, save where SAS 120.15 applies, auditors should as soon as practicable, either : (a) communicate with management and the board of directors including the audit committee, or (b) obtain evidence that they are appropriately informed.

Auditors can also : (a) Report to addressees of the auditor's report on the financial statements (SAS 120.10); (b) Report to third parties (SAS 120.12).

D. CONCLUSION

Even as there are limits to what a regulator can do, the external auditor is also confronted by obstacles which could prevent him from carrying out his duties and responsibilities effectively. Such factors include factors which could affect the independence and objectivity of the auditor. These, however will not be discussed in detail in this paper. According to accounting literature, the traditional role of the audit was **primarily** the detection and prevention of fraud. The **main** objective of the audit **today** is the verification of financial information.[101] Through assisting the regulator in the verification of financial information, he provides assistance to the regulator and gives credibility to such information. This role requires an independent and objective mind. The risks involved in using external auditors include lack of independence and lack of objectivity whilst performing their duties. The performance of non-audit work by external auditors has contributed a great deal to these risks. The European Commission issued a Recommendation "Statutory Auditors' Independence in the EU : A Set of Fundamental Principles" on the 16 May 2002. The new directive introduced requires all firms listed on the stock exchange to have independent audit committees and that auditors/audit partners must be rotated. These measures are all aimed at reducing the risks posed to the auditor's independence and objectivity. However, it does not deal with the separation of auditors from consultancy work (despite the threat of non-audit work to the auditor's independence).

On the 24 July 2002, an immediate review of the regulatory arrangements for the accountancy and audit professions was called for by Patricia Hewitt, Secretary of Sate for Trade and Industry. The purpose of this review was to look at the way the accountancy and audit professions were regulated, consider whether changes should be made and whether there should be a statutory basis for regulation.[102] On the 11 March 2003 the Department of Trade and Industry published a consultation document "Review of the Regulatory Regime of the Accountancy Profession : Legislative Proposals" and the aims and objectives of the new FRC and its Boards have since been published[103] .

Regulators are also mindful of regulatory capture and are putting measures in place to deal with it. To assess these measures, it will be necessary to undertake the comparative study of different jurisdictions to assess them. The existing situation in the UK whereby the FSA is the sole authority involved in the regulatory process exposes it to more “capture” than the situation in Germany whereby a single all-embracing regulator just like the FSA, “The Federal Financial Supervisory Authority (Bundesanstalt fuer Finanzdienstleistungsaufsicht - BaFin) shares responsibilities with the central bank (the Deutsche Bundesbank). As a result of these differences , the banking supervisory process in the UK would not only benefit from the expertise of having more external auditors share regulatory responsibilities with the FSA but would also help the FSA avoid regulatory capture. In order to supervise banks more effectively, knowledge of the workings of monetary dynamics is an essential tool. In monetary policy, the main questions are how far unemployment can fall before inflation starts to rise and how quickly inflation can be curbed if it goes up for any reason.[104]. For this reason, the FSA needs to get closer to the market and is in need of early warning indicators about market changes and developments – indicators which would ideally have benn provided by the Bank of England's expertise. However, since the Bank of England is not involved the bank supervisory process, the external auditor could help fill this gap by getting closer to the market and consumers and also reduce the likelihood of the FSA getting 'captured' by the market.

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[1] Oxford Brookes University, School of Social Sciences and Law. The usual disclaimers apply

[2] See G. McMahon ‘Regulatory capture : Causes and Effects’ at http://www.iipe.org/conference2002/papers/McMahon.pdf .Also see R. Posner 'Theories of economic regulation' (1974) 5 Bell Journal of Economics and Management Science pp 335-358; G. Stigler ' The theory of economic regulation' (1971) 2 Bell Journal of Economics and Management Science pp 3-21; J Laffont and J Tirole ' The politics of Government Decision Making : A Theory of Regulatory Capture' (1991) 106 Quarterly Journal of Economics pp 1089-1127.

[3] ibid

[4]*Responsive Regulation and Liquor Licensing in New Zealand* (1998)

[5] K Mwenda and A Fleming ‘International developments in the organizational structure of financial services supervision’ (paper presented at a seminar hosted by the World Bank Financial Sector September 2001) 12

[6] E Ferran ‘Examining the UK’s Experience in Adopting the Single Financial Regulator Model’ (2003) 28 Brooklyn Journal of International Law p 7

[7] ibid

[8] ibid p 8

[9] D Llewellyn *The Economic Rationale For Financial Regulation* (Financial Services Authority London Occasional Paper 1 April 1999) 8

[10] ibid p 9

[11] supra note 6 p 22

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