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Financial Regulation for a Better Society

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Abstract: The benefits of top down financial reporting regulation over the past eight decades are less obvious than its failures to achieve the purported goals. Perhaps it is time to give a chance to an alternative approach of regulatory competition.

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Accounting Regulation and the Public Good

1. “Why and How EFRAG was Reformed” by Philippe Maystadt, <https://doi.org/10.1515/ael-2017-0010>
2. “A Speech on “Why Accounting Matters: A Central Bank Perspective”” by Claudia Schwarz, <https://doi.org/10.1515/ael-2017-0012>
3. “Thin Political Markets in Accounting and Beyond: Lessons for Leadership Education” by Karthik Ramanna, <https://doi.org/10.1515/ael-2017-0011>
4. “Financial Regulation for a Better Society” by Shyam Sunder, <https://doi.org/10.1515/ael-2017-0013>
5. “Open Debate on Accounting Regulation and the Public Good” by Imke Graeff, <https://doi.org/10.1515/ael-2017-0023>

Thank you for this opportunity to join you in discussing what we can do to improve accounting and financial regulations to help the European economy and society. It was a problem that deeply engaged Jérôme Haas during the many years of his exceptional public service. It was my privilege to know him for a few brief years before he was taken away from us. Unique among accounting regulators, he used his broad vision and foresight to push French and international accounting towards addressing these problems at a fundamental and long-term level. It is an honour to attend this conference to address a challenge of such deep interest to him. As members of the accounting community, perhaps this is the best way we can pay our tribute to him. Let me start by thanking Jérôme for

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bringing a breath of fresh air to the world of accounting regulation and thank you, Leah, for being with us this morning to share our memories and gratitude.

In this talk, I would like to ask: Why do we have financial regulation? What are the challenges of financial regulation and how can we meet these challenges? What are the false starts and prospects for the future?

Why engage in financial regulation? The question is worth asking, even if the answer may be obvious to some. Finance revolves around an exchange of resources separated in time. You give me something today, and I will give you something tomorrow, or a month later, or a year later, or ten years later, or maybe never. There is a time lag that creates commitment, uncertainty, moral hazard, and disappointment. That is the fundamental nature of finance. How do we reap the benefits of finance for society, mostly in the form of investment and consumption, without incurring excessive frictional costs? That is the fundamental challenge, and is common to various aspects of finance: insurance, banking, real estate, consumer finance, brokerage trading, investment banking and management, financial reporting and auditing. All of these disciplines call for some form of regulation to control the frictions. As the following examples show, the absence of regulation often results in chaos.

AIG, an American insurance company, collected billions of dollars in premiums to write credit default swaps (CDSs), which are insurance policies against credit defaults. In the absence of regulatory oversight applicable to other forms of insurance, they did not keep the reserves to meet their obligations to pay the claims during the financial crisis and the federal government stepped in with taxpayers' money to prevent a chain of financial failures. Regulation is necessary in banking for the safety of depositor's money because banks can increase their profitability by taking on excessive leverage at its depositors and deposit insurer's expense.

In real estate, regulation ensures the quality of construction and maintenance and supports ownership rights. In consumer finance, regulation protects consumers from unfair business practices and misinformation as well as from usury. In brokerage and investment management, regulation protects consumers from misinformation or missing information, and protects their wealth from misappropriation and excessive fees. In trading, regulation ensures that the consumers get the best available price and protects the market from insider trading. Clients in investment banking also are susceptible to misinformation about investment prospects, bad investment management, and misappropriation of funds. In financial reporting, closer to our discussion here, regulation is intended to promote measurement and disclosure and financial status and performance of organisations and businesses, NGOs and government sectors. And finally, in auditing various kinds of organisations, regulation is intended to ensure that audits protect the interests of investors and other parties.

There are special challenges, however, in regulating finance. Regulating objects of physical substance such as medicine, baby clothes, food, and cars is easier. The reason is that a physical object exists independent of regulation, and its properties are difficult to change. For example, a regulator can say: “A room of 200 square meters must have at least four exits.” The fire marshal can check if the room has the requisite number of exits for its size; one cannot fake that easily. In contrast, objects of finance are virtual, not real. All the finance examples mentioned above involve virtual objects; they are defined by an incomplete contract – there is no way to completely define an object of finance. You cannot completely define any contract in finance and oftentimes they are not even written contracts, they are understandings and expectations without any physical substance. This means that their attributes are easy to change and you can add new attributes easily and at any time. Financial reporting, as well as other kinds of financial regulation, lives in this world with financial engineering. Financial engineers are adversaries, not friends, of regulators. They make it difficult to have written financial regulations to achieve the intended effects. A regulator may take five years to write a rule and it may take less than five hours for financial engineers to find a way around it (Dye, Glover & Sunder, 2015). This raises questions about the general effectiveness of written rules in the presence of financial engineering. If written rules are replaced by discretionary regulation, that too raises the question if such discretion will be exercised fairly.

Let us briefly discuss written regulation. There are reasonable arguments for written regulations. In a fair and democratic system, rules should be written down so they can be applied to everyone. But excessive dependence on written rules also has its disadvantages. As an example, written rules facilitate financial engineering to help the regulatees bypass the intent of the regulators. Computer worksheet technologies such as Microsoft’s Excel software allow the written rules to be programmed and used as an efficient tool for tax-planning across the world. As Excel has spread across the world, the tax rates of multinationals have declined.

Credit rating agencies were supposed to help investors and regulators assess the value of securities offered for sale. Under a system in which the issuers of these securities paid these agencies for the scrutiny, the risks of many securities were grossly under-reported, giving rise to major scandals during the Atlantic Financial Crisis. Foley, 2013 January 15) writes: “Rocked by public and political distaste for the role they played in the global crisis, the big three credit rating agencies were expected to make profound changes – but efforts to reform have come unstuck.” (Foley 2013)

Of the yen-LIBOR manipulation, Mr Hayes of UBS has been recorded saying: “If you pay me fifty thousand or a hundred thousand, whatever you want, I am a man of my word. Just change the LIBOR rate. I do not mind helping you with the

fixings, but I am not setting LIBOR seven points away from the truth". He actually set it two points down. (Cohan 2012)

In bank capital regulation there is no free lunch. They have tried to regulate bank capital for many decades, largely without noticeable success. Basel I lasted for about ten years, followed by Basel II for another ten, until the financial crisis occurred. Basel III came next and within four years, had already seen significant changes in response to rapid financial engineering to outmanoeuvre the written rules. According to OECD (2011), "Capital regulation based on risk-weighted assets encourages innovation designed to circumvent regulatory requirements and shifts banks' focus away from their core economic functions." A large part of this innovation consists of mis-classifying the risk of banks' assets to avoid holding more capital.

In 2007, bank capital was 11 % of risk-weighted assets for the ten largest US banks. However, if goodwill, intangibles and deferred tax assets (which tend to become worthless under financial stress) are excluded, their capital was only 2.8 %. The more arcane and complex the rules for calculating bank capital, the more loopholes banks find to financially engineer their way around the capital standards. Basel III set the capital/asset requirement to 3 % (which is about the same as the actual level the banks had in 2007 leading up to the banking crisis).

According to Hoenig (2012), then Vice Chairman of the US Federal Deposit Insurance Corporation, "Each new Basel (bank capital) standard attempts to correct the errors and unintended consequences of earlier versions. But instead of resulting in better outcomes, each do-over has been more complicated and less effective than the last. Most disturbingly, each fails to provide enough real capital to absorb unexpected shocks to the economy." Accountants and regulators keep trying to out-smart financial engineering, always without success. They seem destined to lose.

Federal bank deposit insurance in the US (and elsewhere) shifted the burden of monitoring levels of bank capital from depositors interested in preserving their money to the employees of regulatory agencies interested in preserving their positions. Regulators let bank capital decline from an average of 10 % to a mere 3 % (even 2 % for some large European banks). With the benefit of hindsight, it might be better to shift some non-trivial proportion of the risk of bank failure to the depositors, so they will be motivated to scrutinise the banks before entrusting their money to them.

Returning to my main point, how long can the regulatory walls of written rules hold against the persistent pressures of financial engineering? Past experience with accounting and financial regulation suggests that the answer is: Not for long. What, then, could be a robust system of regulation which would produce good financial reports?

At least in the UK, and years earlier in the US, ‘true and fair’ was the old standard for good financial reporting. But true and fair is not a rule that you can meaningfully write down. It is a matter of judgment applied to the big picture of a financial report. If executed in good faith, it is fundamentally a good idea. But accounting has chosen to abandon that approach, and shifted its faith to written rules. The last time I looked, there are about 3,000 pages of rules, which are claimed to be ‘principles’ by presumably knowledgeable people. There is no other profession – medicine, law, or dentistry – which has about 3,000 pages of principles. Even guiding principles of religions – any religion – can be written down on a single page, and cover just about every aspect of human life. “Thou shalt not steal” is not implementable without good judgment and the conditions for making such judgments cannot be written down as rules.

Financial reporting and financial engineering have played a cat and mouse game between accounting rule makers and financial rule breakers for decades (Dye et al., 2015). For example, accountants have been trying to get businesses to record or capitalise their long-term leases – such as airplanes – on their balance sheet for over 60 years. During these 60 years, they have issued 65 pronouncements in an attempt to get long-term leases capitalised. How many long-term leases do these rules force to appear on the published balance sheet of corporations? We have not yet managed to get any significant number or amount of long-term leases capitalised. But the accounting rule writers (FASB, IASB, etc.) continue to devise new rules knowing full well that they will lose to financial engineers. What can and should they do?

We have to think about restructuring and designing a process that is robust enough to withstand the tricky nature of financial engineering. What could that process be? Can we devise alternatives or supplements to written standards if such standards alone are not sufficient? In the last 80 years in the United States at least, since the legislation of US federal securities laws, we have increasingly depended on written accounting standards in the hope that they will solve our problem of improving financial reporting and financial regulation. That hope has not yet been fulfilled. I am not aware of surveys or meta studies of research that documents the evidence that today’s financial reports are any better than they were in the 1920s. Perhaps someone will point to such evidence if it exists.

So, the question is, are accountants willing to devise a better strategy? And what could that better strategy be? Why do accountants keep losing the game and yet continue playing the same strategy? Should they try to restructure the game so they might have a chance to win? We are fond of regulatory monopolies in accounting; they exist in almost all accounting domains and virtually every part of the world, including the US and the European Union (EU). The EU granted an accounting monopoly to IASB in 2004, largely because the US had done the same

decades earlier. Accountants find it very difficult to imagine using their judgment in an environment without detailed written rules that they are required to follow; but their dependence on rules make them sitting ducks for financial engineers.

I would like to suggest regulatory competition as an alternative to dependence on rules written by a monopoly regulator (Dye & Sunder, 2001; Sunder, 2002). Two or more sets of regulations could compete for clientele within the same domain. For example, universities compete with competing curricula and course designs for students. Who wants to go to the Sorbonne? Who wants to go to Yale? Stock exchanges compete for corporate listings. In the United States, 50 states compete for corporate charters. Even for the internet, we do not have to have a single standard. In the 1960s, the International Telecommunications Union (ITU), an organisation of some 190 governments of the world, designed ISDN, a circuit switched protocol for connecting phones across the globe by high quality connections by spending billions of dollars. In contrast, a bunch of independent engineers who volunteered to work on a network amongst them designed the TCP-IP protocol. It was a private not-for-profit effort. Our internet today runs on that system because its packet switched protocol is a far better system than the official protocol designed by the ‘experts’ in international telecommunications. The Internet revolution is a result of competition and not the monopoly created by the 190 governments (Jamal & Sunder, 2014).

If accountants allowed competition among two or three regulators, clients could choose among the alternative regulatory systems and pay a fee to the regulator. Competing organisations would try to attract more clients, firms, managers and investors with respect to financial reporting. Competition allows for learning; it allows for comparison; it allows for evolution of social systems that Herbert Spencer wrote about. F. A. Hayek analyzed emergent systems in the social domain because nobody has enough knowledge to design from the top down a good social system. Since there is little agreement on what constitutes a good financial reporting system, it is impossible to design it as you can see by the repeated failures of financial reporting standards (Sunder, 2016a and b).

However, two questions must be addressed about regulatory competition: Will it succumb to a race to the bottom? And, how will regulatory competition help resist financial engineering?

The race to the bottom is the most frequently mentioned danger in accounting regulation, but I believe this premise to be false. Universities compete and there is little evidence of a race to the bottom. Students and university employees can clearly see the quality of education associated with the degree. Similarly, in regulatory competition of financial reporting a greedy manager might be tempted to choose poor standards, but s/he is watched by the investors who monitor the firm and abandon firms for providing poor reports. Therefore, there

exists a disincentive to deliver inferior quality and services and competition helps to constrain, not promote, a race to the bottom.

Under competing standards, rule makers will have reason to develop reporting systems that are more resistant to financial engineering. Under the current system, they do not. Analysts and investors will be more sophisticated in comparing reports from funds that conform to various alternative reporting regimes. They will have better capabilities to analyse and see truth in the engineered financial reports and the competition, than under the comfort of the current monopoly, because false comfort we know can be manipulated.

To summarise, we agree that financial regulation is essential for the economic welfare of society; that is the theme of this conference. The regulation of financial reporting has contributed in creating monopoly regimes, which are susceptible to financial engineering, as evidenced by the 2008 financial crisis. To improve our economic outlook, we need to seriously think about alternative approaches such as regulatory competition in financial reporting. Maybe there are other alternatives, but we need to devise, discuss and debate their merits. We cannot continue to play the game of the past 80 years, because history shows that the current financial reporting strategy is not only a failure, but dangerous to the world economy.

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